77-291

No.

In the Supreme Court of the United States

October Term, 1977

Securities and Exchange Commission, petitioner

v.

Arthur Lipper Corporation and Arthur Lipper, III

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Cases—Continued

In the Supreme Court of the United States

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No.

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

ARTHUR LIPPER CORPORATION AND ARTHUR LIPPER, III

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the Securities and Exchange Commission, petitions for a writ of certiorari to review that portion of the judgment of the United States Court of Appeals for the Second Circuit that modified the Commission's sanction.

OPINIONS BELOW

The opinion of the court of appeals (App. A, *infra,* pp. 1A–28A) is reported at 547 F.2d 171. The orders of the court of appeals denying the Commission's petition for rehearing and its suggestion for rehearing *en banc,* and the dissenting opinion from the order denying the petition for rehearing (Apps. C and D, *infra,* pp. 30A–33A), are reported at 551 F.2d 915. The opinion of the Securities and Exchange Commis-

sion (App. E, *infra*, pp. 34A–79A) is reported at 8 SEC Docket 273.

JURISDICTION

The judgment of the court of appeals was entered on December 10, 1976 (App. B, *infra*, p. 29A). On March 22, 1977, the court denied the Commission's timely petition for rehearing and suggestion for rehearing *en banc* (Apps. C and D, *infra*, pp. 30A–33A). On June 13, 1977, Mr. Justice Marshall extended the time for filing a petition for writ of certiorari to and including August 19, 1977. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the court of appeals exceeded the proper scope of judicial review when, despite its affirmance of the Commission's administrative findings that respondents had aided and abetted serious and willful violations of the federal securities laws, the court set aside the Commission's exclusion of respondents from the securities business, and instead imposed a one-year suspension.

STATUTES INVOLVED

Sections 15(b)(4) (E), 15(b)(6), and 25(a) of the Securities Exchange Act of 1934, 48 Stat. 895, 901, as amended, 15 U.S.C. (Supp. V) 78*o*(b)(4)(E), 78*o*(b)(6), and 78y(a), are set forth in App. F, *infra*, pp. 80A–82A.

STATEMENT

After a lengthy evidentiary hearing, the Securities and Exchange Commission, affirming the decision of its administrative law judge, found that respondents Arthur Lipper Corporation ("Lipper Corp."), a reg-

istered broker-dealer, and Arthur Lipper III ("Lipper"), the president and controlling stockholder of Lipper Corp., had aided and abetted violations of Section 10(b) of the Securities [redacted] Exchange Act of 1934, 15 U.S.C. 78j(b), and Commission Rule 10b-5 thereunder, 17 CFR 240.10b-5 (App. E, *infra*, pp. 34A–79A). The Commission revoked the registration of Lipper Corp. and barred Lipper from further association with any broker or dealer (*id.*, at p. 77A).[1]

The Commission found that the respondents had participated with IOS, Ltd., the investment adviser to certain mutual funds, in defrauding those funds and their shareholders of approximately $1.4 million. The fraud that the Commission found was that Lipper Corp., at IOS's direction, executed securities transactions in the United States over-the-counter securities market for the mutual funds for which IOS was investment adviser; that Lipper Corp. charged the mutual funds commissions that were considerably in excess of its costs, and then remitted 50 percent of these commissions to an American subsidiary of IOS, the investment adviser; and that these remitted commission payments (known as give-ups) inured to the benefit of IOS, and were never fully disclosed either to the funds' shareholders or to their directors. The Commission held that the undisclosed give-up payments violated IOS's fiduciary duties to the funds in violation of Section 10(b) of the

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[1] The administrative law judge had recommended that Lipper Corp.'s registration be suspended for 12 months with respect to transactions in over-the-counter securities, and that Lipper be barred from association with any broker or dealer for the same period (App. E, *infra*, p. 39A).

Securities Exchange Act and Rule 10b-5 thereunder, and that the respondents were active and knowing participants in the perpetration of that fraud (App. E, *infra,* pp. 48A-49A).

With respect to the sanctions to be imposed, the Commission stated that because of the Administrative Law Judge's "long experience and great acumen," it had considered with "special care" his recommendation of one-year suspensions for both Lipper and Lipper Corp., but had concluded that a more severe sanction was required. The Commission agreed with the Administrative Law Judge that " 'the Lipper respondents' violations were serious and long continuing,' " and his finding that App. E, *infra,* p. 75A):

> Lipper * * * did nothing to ameliorate [the] fraudulent practice until his own * * * financial success [was] assured. The picture that emerges from the record is of a man intent on personal gain and willing to take the risk that the scheme by which he could reach his goal would not be found illegal.

The Commission stated (App. E, *infra,* p. 76A) that "[w]e cannot be as sanguine as the administrative law judge about future derelictions of this sort by the Lipper respondents. What we have before us is not some isolated indiscretion." The Commission concluded (*id,* at pp. 76A-77A; two footnotes omitted):

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[2] The Commission stated (App. E, *infra,* p. 76A): "As we see it, the Lipper respondents were as culpable as IOS. In situations of this sort, the remitting broker and the receiving institutional manager are acting *in pari delicto.* Neither can accomplish his ends without the other. * * * Lipper Corp. owed its existence to IOS. And the Lipper IOS relationship was rooted in the over-the-counter give-ups that flowed from Lipper to IPC."

> Congress, in writing Section 15(b) of the Exchange Act, viewed past misconduct as the basis for an inference that the risk of probable future misconduct was sufficient to require exclusion from the securities business. Having been directed by the Act to draw that inference whenever our discretion leads us to consider it appropriate, we must do so if the legislative aim is to be attained. We think the likelihood of future misconduct by the Lipper respondents sufficient to call for their exclusion from the securities business.[72] Moreover, as we have indicated in discussing IOS, that sanction will have a deterrent effect on other broker-dealers who may be inclined to participate in the fraudulent schemes concocted by investment company managers.
>
> [72] This is so even though it appears that some years have now elapsed since they were last engaged in the securities business. That obviated any need for speedy action by us. However, the Lipper respondents are still legally free to engage in the securities business. Since we believe that this would be incompatible with the public interest, we are constrained to take appropriate preventive action.

The court of appeals upheld the Commission's findings that respondents had aided and abetted violations of Section 10(b) and Rule 10b-5. The court held that respondents were central figures in a clever fraud—a fraud that was "almost too clear for argument" (App. A, *infra,* p. 12A).

However, the court rejected the Commission's revocation of Lipper Corp.'s registration as a broker-dealer and the bar against Lipper's future association with any broker or dealer as "too severe" (App. A, *infra,* p. 26A). The court stated (*id.,* at p. 28A)

that under the Act the Commission's choice of sanctions was "limited to a suspension of not more than twelve months or a revocation or bar," and that "under the special circumstances of this case, selection of the latter was an abuse of discretion." The court accordingly "limited" the sanctions "to suspension of Lipper Corp.'s registration for 12 months * * * and the barring of Lipper from association with any broker or dealer for the same period" (*id.*, at p. 28A).

REASONS FOR GRANTING THE PETITION

In substituting a one-year suspension from the securities business in place of the bar of respondents that the Commission concluded was necessary to protect investors, the court of appeals exceeded the proper scope of judicial review of agency sanctions, contrary to the teaching of this Court in *Butz* v. *Glover Livestock Commission Co.,* 411 U.S. 182. In that case, which the court of appeals merely referred to in passing in a footnote (App. A, *infra,* p. 25A n. 10), the court of appeals upheld the finding of the Secretary of Agriculture that the company had violated the Packers and Stockyards Act by shortweighing cattle, but set aside the Secretary's suspension for 20 days of the company's registration under the Act. In holding that "the setting aside of the suspension was an impermissible judicial intrusion into the administrative domain" (411 U.S. at 183), the Court stated (411 U.S. at 185–186):

> The applicable standard of judicial review in such cases required review of the Secretary's

> order according to the "fundamental principle . . . that where Congress has entrusted an administrative agency with the responsibility of selecting the means of achieving the statutory policy 'the relation of remedy to policy is peculiarly a matter for administrative competence.'" *American Power Co.* v. *SEC,* 329 U.S. 90, 112 (1946). Thus, the Secretary's choice of sanction was not to be overturned unless the Court of Appeals might find it "unwarranted in law or without justification in fact. . . . *Id.* at 112–113 * * *."

Similarly, the courts of appeals repeatedly have recognized that where the sanction of the Commission is authorized by statute, the courts should not substitute their view of what is appropriate to protect the public interest for that of the Commission. *E.g., O'Leary* v. *Securities and Exchange Commission,* 424 F. 2d 908, 911–912 (C.A. D.C.); *Pierce* v. *Securities and Exchange Commission,* 239 F. 2d 160, 163 (C.A. 9); *Associated Securities Corp.* v. *Securities and Exchange Commission,* 293 F. 2d 738, 741 (C.A. 10); cf. *Haltmier* v. *Commodity Futures Trading Commission,* 554 F. 2d 556, 563–564 (C.A. 2). Because "the investing and usually naive public needs special protection in this specialized field," *Norris & Hirshberg, Inc.* v. *Securities and Exchange Commission,* 177 F. 2d 228, 233 (C.A. D.C.), certiorari denied, 337 U.S. 867, "[f]ailing a gross abuse of discretion, the courts

not
should attempt to substitute their untutored views as to what sanctions will best accord with the regulatory powers of the Commission." *Tager* v. *Securities and Exchange Commission,* 344 F. 2d 5, 9 (C.A. 2). See also *Berko v. Securities and Exchange Commission,* 316 F. 2d 137, 141 (C.A. 2).

Under the rule of *Glover Livestock* and the other cases cited above, the court of appeals should have sustained the Commission's sanctions and not substituted its own view of the proper remedy for the expert judgment of the agency.

1. The Commission's prohibition against respondent's further participation in the securities business was not "unwarranted in law or . . . without justification in fact" (*Glover Livestock, supra,* 411 U.S. at 186).

a. The Act expressly authorizes the Commission to "censure, * * * suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds * * * that such censure, * * * suspension, or revocation is in the public interest" and that fully aided * * * the violation by any other person" of the Act or of a Commission rule or regulation thereunder (Section 15(b)(4)(E), 15 U.S.C. (Supp. V) 78*o*(b) (4)(E)), and to censure, bar or suspend for not more than a year any person from being associated with a broker or dealer if the Commission finds "that such censure, * * * suspension, or bar is in the public interest" and that such person has committed such violation (Section 15(b)(6), 15 U.S.C. (Supp. V) 78*o*(b)(6). Although Congress has thus

left it to the discretion of the Commission to determine which sanction "is in the public interest," the very range of sanctions the legislature has authorized—ranging from the relatively minor one of censuring to the ultimate one of barring from the business—reflects a congressional recognition that expulsion is generally the appropriate sanction for a serious violation.[3] As the commission correctly concluded in this case, the statutory scheme for sanctions indicates that where, as here, there has been serious misconduct, the proper "inference [is] that the risk of probable future misconduct was sufficient to require exclusion from the securities business" (App. E, *infra*, p. 76A). Cf. *Glover Livestock, supra*, 411 U.S. at 187.

The court of appeals did not question the seriousness of the respondents' violations, and it stated that

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[3] The legislative history of the Securities Act Amendments of 1964, 78 Stat. 565, which first authorized the Commission to bar persons from associating with a broker or dealer and to suspend a broker or dealer's registration as an alternative to revoking it, supports this view. The 1964 amendments were the consequence of the Commission's Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 1, p. 327 (1963) which concluded that "[f]or isolated instances of illegal selling in a large essentially well-run firm, the Commission's sanctions [which then were limited to revocation of registration] may often be too severe to justify their use." In granting the Commission authority to use less severe sanctions, Congress presumably intended the agency to use them in cases where an isolated violation had occurred; there is no suggestion, however, that Congress did not expect the Commission to continue to revoke the registrations of broker-dealers who had committed serious or long-continuing violations, or that it should refrain from barring from association with any broker or dealer a person who had committed such a violation.

if the Commission were authorized to suspend for 24 months and had done so, the court "surely would not interfere" (App A, *infra*, p. 28A). Congress, however, has provided that it is the Commission and not the reviewing court that is to determine in the particular case whether expulsion from the business rather than suspension "is in the public intrest". As we now show, the Commission was fully justified in concluding that expulsion was the appropriate remedy in this case.

b. The Commission's decision to exclude respondents from the securities business was not "without justification in fact." To the contrary, the record fully supports that decision.

As noted in the statement, the Commission found the respondents' violations had been serious and long continuing, that respondents were as culpable as IOS, whose "serious" and "pervasive" misconduct led the Commission to bar it from association with any broker or dealer (App. E, *infra*, p. 74A), and that Lipper is "'a man intent on personal gain and willing to take the risk that the scheme by which he could reach his goal would not be found illegal'" (*id.*, at p. 75A). In view of the serious violations respondents had committed, the Commission was justifiably concerned about "future derelictions of this sort by the Lipper respondents" (*id.*, at p. 76A), and reasonably concluded that "the likelihood of future misconduct by the Lipper respondents is sufficient to call for their exclusion from the securities business" (*id.*, at pp. 76A–77A). This was a judgment that the

Commission was entitled to make. The Commission also justifiably took account of the fact that this sanction "will have a deterrent effect on other broker-dealers who may be inclined to participate in the fraudulent schemes concocted by investment company managers" (App. E, *infra*, p. 77A). Cf. *Glover Livestock, supra*, 411 U.S. at 187–188.[4]

2. The reasons the court of appeals gave for rejecting the Commission's sanction, neither individually nor collectively, justify its action. They are essentially similar to those this Court held in *Glover Livestock* did not justify such an "impermissible intrusion into the administrative domain" (411 U.S. at 188).

a. The court of appeals expressed concern over an alleged "disparity between the sanctions invoked against [respondents] and that imposed on two other broker dealers whose violations were perhaps more clear" (App. A, *infra*, p. 27A). In rejecting a similar justification for judicial modification of an adminis-

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[4] With regard to the use of sanctions to effectuate statutory objectives, the Commission has stated: "When we deal with these matters, we must weigh the effect of our action or inaction on the welfare of investors as a class and on standards of conduct in the securities business generally. If these proceedings are to be truly remedial, they must have a deterrent effect on others in the business who may otherwise be tempted to succumb to the lethal admixture of mindless enthusiasm and overweening greed that so often brings fraud and deceit in its wake. Compare *Arthur Lipper Corporation*, Securities Exchange Act Release No. 11773 [citation]." *Matter of Richard C. Spangler, Inc.*, Securities Exchange Act Release No. 12104 (February 12, 1976), 8 SEC Docket 1257, 1268 n. 67.

trative sanction in *Glover Livestock,* this Court ruled that "[t]he employment of a sanction within the authority of an administrative agency is thus not rendered invalid in a particular case because it is more severe than sanctions imposed in other cases" (411 U.S. at 187). See also *Hiller* v. *Securities and Exchange Commission,* 429 F. 2d 856, 858 (C.A. 2): "[W]e cannot disturb the sanctions ordered in one case because they were different from those imposed in an entirely different proceeding." Moreover, the sanctions in the two cases to which the court of appeals apparently referred resulted from settlements, not from [redacted] litigated decisions.[5]

b. The court stated (App. A, *infra* p. 27A) that it was moved "by the inordinately long time in which this proceeding [had] been pending"—during which there was a "cloud" over respondents' heads. But in *Glover Livestock* the Court held that it was improper for a reviewing court to substitute its judgment for the agency's with respect to the sanction because of the adverse publicity resulting from the administrative proceeding. 411 U.S. at 188–189. Cf. *Haltmier* v. *Commodity Futures Trading Commission,* 554 F. 2d

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[5] The court apparently referred to orders in two other proceedings that were attached to the respondents' reply brief. See *Matter of Dishy, Easton & Co.*, Securities Exchange Act Release No. 8702 (September 23, 1969); *Matter of Hertz, Warner & Co.*, Securities Exchange Act Release No. 8874 (April 29, 1970).

556, 564 (C.A. 2), where the court noted that "personal detriment * * * is suffered by many persons who commit derelictions resulting in civil or other sanctions but [is outweighed by] 'the necessity of protection to the public * * *' ".

Any delay in completing the administrative proceeding would not justify judicial modification of an otherwise valid sanction, which is designed to protect the public interest and not to punish the respondents for their wrongdoing. Cf. *National Labor Relations Board* v. *J. H. Rutter-Rex Mfg. Co.,* 396 U.S. 258. The Commission's delay in completing its proceedings in this case does not justify permitting respondents to return to the securities business, unless the Commission first determines that they should be permitted to do so.[6]

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[6] See *Applications for Relief from Disqualification*, Securities Exchange Act Release No. 11267 (February 26, 1975), 6 SEC Docket 346. In that release the Commission enumerated certain factors which it would consider in the exercise of its discretion in determining whether to permit an individual's re-entry into the securities business. The Commission stated:

"The Commission recognizes that situations may exist where, in light of changed circumstances and after the passage of a period of time, it may appear appropriate to the Commission, in its discretion, to permit a disqualified individual or firm to have the disqualification lifted if, in general, the applicant can make a showing satisfactory to the Commission that re-entry into the securities business would be consistent with the public interest [footnote omitted]."

6 SEC Docket *id.* at 346; see also *Hanly* v. *Securities and Exchange Commission,* 415 F.2d 589, 598–599 (C.A. 2).

c. Finally, the court gave some weight to the recommendation of the administrative law judge that a one-year suspension would be appropriate. As the court itself recognized, however, "the Commission is in no way bound by the views of the ALJ" (App. A, *infra,* p. 27A). The determination of the appropriate sanction is a policy and not a fact-finding function, and it is one that Congress has given to the agency, not to its hearing officer. The Commission stated that it had considered the administrative law judge's views with "special care," but concluded that a more severe sanction was necessary "if the legislative aim is to be attained" (App. E, *intra,* p. 76A).[7]

3. In *Glover Livestock,* the court of appeals apparently recognized the limited scope of judicial review of administrative sanctions (see 411 U.S. at 186),

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[7] The court referred to two other factors that apparently influenced its decision. First, it noted that respondents' violations occurred during a period of regulatory uncertainty about the legality of give-ups (App. A, *infra*, p. 27A). The give-ups as to which there was uncertainty, however, resulted from transactions on securities exchanges that required their member brokers to charge minimum commissions without regard to their costs in executing transactions. They were a far cry from the violations in this case, where all of the transactions occurred in the over-the-counter market in which there was no comparable minimum commission requirement. The court apparently recognized the distinction, since it pointed out that even during that period there was nothing to suggest that the give-ups in this case were legal (*id.*, at p. 27A).

Second, the court noted that respondents had acted on advice of counsel—but the court did not believe that such counsel was "disinterested" (*id.*, at p. 27A).

but nevertheless exceeded the bounds of its authority by modifying the administrative sanction. This Court corrected the error. In the present case the court of appeals similarly paid lip service to the standard of review, but again went beyond its authority by substituting its judgment for the Commission's with respect to the sanction that the public interest requires. This Court should again correct the error.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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August 1977.

243-942 · 77——2

APPENDIX A

United States Court of Appeals for the Second Circuit

No. 165—September Term, 1976.

(Argued October 21, 1976 Decided December 10, 1976.)

Docket No. 76-4067

ARTHUR LIPPER CORPORATION AND ARTHUR LIPPER, III, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

Before FRIENDLY, HAYS and MULLIGAN, *Circuit Judges.*

FRIENDLY, *Circuit Judge:*

This petition to review a disciplinary order of the Securities and Exchange Commission (SEC), Securities Exchange Act Release No. 11773 (Oct. 24, 1975), is the latest chapter in the extensive litigation resulting from the financial debacle of IOS, Ltd., S.A. (IOS) and the off-shore funds for which it was investment adviser and distributor. *See Bersch* v. *Drexel Firestone, Inc.,* 519 F.2d 974 (2 Cir), *cert. denied,* 423 U.S. 1018 (1975); *IIT* v. *Vencap, Ltd.,* 519 F.2d 1001 (2 Cir. 1975). We deal here with an order under § 15 of the Securities and Exchange Act, 15 U.S.C. § 78o, which revoked the broker-dealer registration of

Arthur Lipper Corporation (Lipper Corp.) and barred Arthur Lipper III (Lipper), its principal owner, from association with any broker or dealer. The order, dated October 24, 1975, was predicated on violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and the Commission's Rule 10b–5, 17 C.F.R. 240.10b–5, during 1967 and 1968. We confirm the decision that a violation occurred but modify the penalty to suspension for a period of 12 months from the effective date of the SEC's order.

I. The Facts, and the Proceedings Before the SEC

The complaint concerns transactions whereby at the direction of Edward M. Cowett, executive vice-president and director of IOS, Lipper Corp. turned over to IOS's 80%-owned subsidiary Investors Planning Corporation (IPC), a registered broker-dealer and a member of the National Association of Securities Dealers, Inc. (NASD), a total of $1,450,000, out of the commissions earned by Lipper Corp. on over-the-counter (OTC) transactions for the account of three off-shore funds for which IOS or one of its affiliates was investment adviser. These were Fund of Funds, Ltd. (FOF), a Canadian corporation which invested chiefly in United States mutual funds and also was the sole owner of another investment company, FOF Proprietary Fund, Ltd. (FOF Prop.); International Investment Trust (IIT), organized under the laws of Luxemburg, which invested in companies throughout the world; and Regent Fund Ltd. (Regent), a Canadian investment company with investments in both Canada and the United States. IIT and Regent had no American shareholders; FOF had some 3,000

of a total of over 100,000, although the shares so owned had been acquired without any registration of FOF shares under § 6 of the Securities Act of 1933, 15 U.S.C. § 77f.

IOS had itself been a registered broker-dealer with its principal place of business in Geneva, Switzerland. In 1965, it acquired IPC, based in New York, apparently with a view to building up IPC, which had been operating at a loss, as a vehicle for IOS's American securities business. This plan was shattered and a revamping of IOS's method of doing business was compelled by a SEC order of May 23, 1967, accepting an offer of settlement of a proceeding it had brought on February 3, 1966 against IOS, Bernard Cornfeld (its organizer), Cowett and others. This order provided, so far as here pertinent, that IOS would withdraw its broker-dealer registration; that IOS, FOF, IIT and any investment company affiliated with any of them should conduct no activity subject to the SEC's jurisdiction except as provided in the order; and, save for qualifications not here material, that within 16 months IOS should dispose of its entire interest in IPC. The effect of the order was to require IOS to devise some method whereby orders for transactions on United States stock exchanges or in the OTC market would have to be placed with exchange or NASD members having offices abroad [1] or with foreign broker-dealers who in turn would refer the orders to American broker-dealers able to execute them. The order also furnished IOS an incentive to build up the value of its equity in IPC in order to increase the price it could obtain upon the required sale.

[1] Petitioners assert and the SEC does not dispute that all such offices were operated by members of the New York Exchange.

Anticipating the settlement, Cowett approached Lipper, a partner in the New York Stock Exchange (NYSE) firm of Zuckerman, Smith & Co., to ascertain whether the firm would be interested in opening branch offices in Geneva and London, together with the extensive communications network that would be needed for the purpose of serving as coordinating agent for the flow of IOS brokerage transactions. The other partners in Zuckerman, Smith & Co. declined the proposal although they were willing to have the firm act as clearing agent if Lipper decided to withdraw and form his own company, which would become a registered broker-dealer and member of NYSE and NASD for the purpose desired by IOS. Lipper indicated his interest to Cowett, and proceeded to make the necessary arrangements. His compensation was to be in commissions earned on IOS generated transactions both on and off the exchanges, as to which his company was to be in a favored position.

The Constitution of the New York Stock Exchange required Lipper Corp. to charge the three off-shore funds the fixed commissions then in effect on transactions executed on that exchange and forbade any rebates to them. Until December 5, 1968, NYSE allowed customer-directed give-ups on NYSE transactions to other NYSE members. The record is silent how far IOS directed Lipper Corp. to make such give-ups; in any event the SEC makes no complaint against Lipper Corp. with respect to NYSE transactions. The conduct of which it does complain relates to OTC transactions for the three off-shore funds. As to these also Lipper Corp. charged the commissions provided by the NYSE minimum rate schedule. However, as Lipper anticipated, directions were received from Cowett to give up 50% of these commissions to

IPC.[2] Pursuant to these instructions Lipper Corp., during the period from July 10, 1967, to August 5, 1968 remitted to IPC approximately $1,275,000, about 50% of the commisisons paid it by FOF Prop., IIT and Regent Fund on OTC transactions.[3] In addition, because cash was required for IPC before September 30, 1968, in order to meet warranties in a subsequently aborted contract for the sale of IPC, Cowett, as president of FOF Prop., by letter dated August 14, 1968, requested that, over and above the "regular" 50% give-up, Lipper Corp. should make additional give-ups to IPC of $175,000 on or before August 30, 1968, and another $175,000 on or before September 30, 1968. Lipper demurred to the size of the request, telling Cowett that no more than an extra $175,000 should be paid. On August 28 Lipper Corp. sent this extra sum, bringing the total give-ups to IPC to some $1,450,000. The Commission found that neither IOS nor IPC rendered services to the funds in return for these give-ups.

[2] By letter dated June 29, 1967, Cowett, as president of FOF Prop., directed Lipper Corp. to give up to IPC "the maximum give-up (50%)" on commissions earned on OTC transactions for the account of FOF Prop. On July 11, 1967, at a representative of IIT Management Co., (S.A.), an IOS affiliate, Cowett gave similar written instructions with respect to OTC transactions for the account of IIT. By letter dated March 15, 1968, Cowett as vice president of Canadian Fund Management Company Limited, also an IOS affiliate, confirmed an earlier request for similar give-ups on OTC transactions effected on behalf of Regent Fund, Ltd.

[3] The details were:

	Gross commissions	Give-ups
FOF prop	$1, 974, 064	$950, 821
IIT	636, 423	312, 175
Regent fund	28, 670	12, 521
Total	2, 639, 157	1, 275, 517

No disclosure of the Lipper Corp.-IPC give-ups was made to the shareholders of FOF (the sole owner of FOF Prop.), of IIT or of Regent Fund. No such disclosure was made directly to the directors of IIT or of Regent Fund. Apparently the most nearly complete disclosure occurred at a meeting of the board of directors of FOF held in Acapulco, Mexico, in April 1968, at which Lipper was present, when Allan F. Conwill, Esq., a director of FOF and counsel for it, IOS, Lipper Corp. and Lipper, informed the FOF directors of the arrangements outlined above; he also advised that Lipper Corp. was in effect required to charge the minimum NYSE commissions for OTC transactions; that there was no legal way for Lipper Corp. to refund any part of such commissions to FOF; that the SEC staff took the position that any give-up on OTC business was a fraud *per se* since there was no fixed rate commission structure on OTC transaction and willingness to give-up a part of the commission showed that the broker would have been willing to take less; but that he considered this position to be unfounded in law. There is no evidence that anyone suggested exploration by outside counsel of the validity of Mr. Conwill's view that Lipper Corp. had to charge the minimum NYSE commission on OTC transactions or that no way could be found whereby the shareholders of FOF would benefit from give-ups to IPC.

Upon these facts and others that will be stated in our discussion, Chief Hearing Examiner, now Administrative Law Judge (ALJ), Blair found on June 11, 1971 that Lipper Corp. and Lipper had willfully violated and willfully aided and abetted violations of § 10(b) of the 1934 Act and Rule 10b-5. Overruling both the assertion of the petitioners that no

sanctions should be imposed and the staff's contention that the registration of Lipper Corp. should be cancelled and Lipper should be permanently barred from the securities business, he determined that a suspension of one year from the effective date of the order would be the proper sanction as to both. Lipper and Lipper Corp. and the staff filed petitions for review by the Commission, which heard argument on August 28, 1972. By a decision filed on October 24, 1975, the SEC sustained the ALJ's conclusion with respect to violations but directed the drastic remedies of cancellation of Lipper Corp.'s registration and the permanent barring of Lipper from the securities business urged by the staff. Petitioners sought rehearing on the sole basis that three of the four Commissioners who participated in the decision had not been members at the time of argument. The petition for rehear-
Sections 15(b)(4) and (6) of the Securities Exchange Act Release No. 11980. This petition for review followed.

II. Liability

Section 15(b)(4) and (6) of the Securities Exchange Act authorize the SEC to suspend for a period not exceeding twelve months or to revoke the registration of any broker or dealer or to bar or suspend for a period not exceeding twelve months any person from being associated with a broker or dealer on various grounds. One is willful violation of any provision of the Act or any rule or regulation thereunder; another is willful aiding, abetting, counseling, commanding, inducing or procuring any such violation. The familiar Rule 10b-5 reads as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or in-

strumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

There is some initial surprise in seeing Rule 10b–5 invoked where the fraud relates not, as in the usual case, to a particular securities transaction but to a course of dealing in securities regardless of their identity. However, the language of the Rule is broad enough to include the latter type of case and petitioners do not urge that the Rule has no application to a course of dealing where the fraud concerns the overall relation of broker and customer rather than the overvaluation or undervaluation of a security sold or purchased. We see nothing in *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723 (1975), that would militate against application of the Rule in a situation like that here before us, though "the terms 'purchase' and 'sale' are relevant . . . to the question of statutory coverage" even in other than private actions, *SEC* v. *National Securities, Inc.,* 393 U.S. 453, 467 n.9 (1969).

Portions of the Commission's decision seem to take the view, which had been the staff's principal reliance at the hearing and was also stressed in the oral argument of counsel before us, that any give-up of a com-

mission on an OTC transaction is *per se* a "device, scheme, or artifice to defraud." In support of this the Commission points particularly to two passages in its report of December 2, 1966, on the Public Policy Implications of Investment Company Growth (hereafter PPI), H.R. Rep. No. 2337, 89th Cong., 2d Sess. These are:

> A directed give-up of a portion of the commission charged for handling a transaction for a fund in the over-the-counter market would be a patent waste of investment company assets. Since the over-the-counter market in both listed and unlisted securities is a negotiated market, which is not governed by fixed prices or minimum commission rate schedules, any willingness of the executing broker or dealer to allow his customer to direct a give-up of a portion of his commission or markup to dealers in fund shares in and of itself shows that a lower price or commission could have been negotiated.

and

> In the over-the-counter markets, where brokerage costs are subject to negotiation, give-ups of commissions to brokers who perform no necessary function in connection with a transaction have long been recognized as improper and illegal. Give-up practices have been tolerated in the exchange markets only because brokerage costs are fixed by the exchange minimum commission rate schedules.

Id. at 178, 185 (footnote omitted).[4]

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[4] The Commission relies also on a July 18, 1966 letter from Irving M. Pollack, then Director of the Division of Trading and Markets, to the presidents of the various stock exchanges and of the NASD. One sentence in the three and one-half pages of single spaced text of the letter, which expresed concern about the give-up problem generally, said:

Insofar as the Commission would attribute legal force to these statements in PPI, we must disagree. While the Report was transmitted to Congress by the Chairman of the Commission pursuant to § 14(b) of the Investment Company Act, it constituted information for the legislature, not a rule having the force of law for the industry, as would a regulation adopted pursuant to 5 U.S.C. § 553. Indeed, we doubt whether these two passages from a 346 page report would qualify even as an "interpretative rule" or a "general statement of policy." In saying this we are quite aware of the importance attached to other portions of PPI in *Moses* v. *Burgin*, 445 F.2d 369, 383–84 (1 Cir.), *cert. denied*, 404 U.S. 994 (1971), and in *Fogel* v. *Chestnutt*, 553 F.2d 731, 734–37, 749 (2 Cir. 1975), *cert. denied*, —— U.S. —— (1976), 45 LW 3250. However, those cases cited PPI as placing the mutual fund industry on notice that the SEC believed there were opportunities for advantaging stockholders that ought to be explored and explained to the disinterested directors, not as having independent legal force. So here we regard the quoted statements from PPI as doing no more than warning the industry what position the Commission would be likely to take with respect to customer-directed give-ups in the OTC market.

"In this connection, we consider it significant that give-ups in the over-the-counter market have long been recognized to be improper and illegal."

Apart from the fact that the letter came from a staff member (albeit a high one) rather than from the Commission, we can hardly regard such an incidental statement, for which no explanation was given, as putting the entire industry on sufficient notice of the Commission's views.

We are not persuaded that any such all encompassing across-the-board *per se* principle as stated in PPI would be sustainable in the absence of a Commission rule. It is true that the source of the practice whereby the managers of investment companies directed executing brokers to give up a part of their commissions to other brokers who furnished services in selling investment company shares and in providing research lay in the inordinate profits a few executing brokers would receive under the fixed commission rate structure prevailing on the exchanges. See *Fogel* v. *Chestnutt, supra,* 533 F.2d at 735–36. We are not certain, however, that even after PPI, if the manager of an investment company determined that the interests of the company would be served by paying fixed commission rates in OTC business, with customer-directed give-ups to brokers who had furnished sales or research service and disinterested directors, on full disclosure, had joined with others in a good faith determination that this was in the fund's best interest, this would have violated Rule 10b–5. At least we would find it difficult to reach such a conclusion on this record, which contains no evidence that commissions on OTC agency business were in fact the subject of negotiation in 1967 or 1968; rather, as the Commission seemingly concedes in its opinion, a purchaser or seller unwilling to pay the fixed commissions generally charged on OTC business, because of the size of the transaction or for other reasons, would deal with a market-maker as a principal—a course which the 1967 settlement precluded IOS from following unless an American firm with an office outside the United States happened to be a market-maker in the particular issue in which IOS was interested.

However, we find it unnecessary to decide whether the extreme position thus far discussed is sustainable. The Commission based its decision primarily on the ground that IOS and its affiliates committed a fraud on the funds by diverting to themselves, through IPC, rebates which belonged to the funds while IPC was doing nothing in return, and that Lipper and his company willfully aided and abetted this. The proposition that it is a fraud on the fund for a manager simply to pocket give-ups which he has diverted to himself is almost too clear for argument. While there has been controversy, illustrated by the *Moses* and *Fogel* decisions, how far an investment adviser was bound to secure give-ups when these were attainable, there has been and could be no question that if these were obtained, they must be applied for the benefit of the fund, either by direct payment or as a reduction in the advisory fees. See statement of then General Counsel Loomis, Securities Exchange Act Release No. 8746 (Nov. 10, 1969); *Provident Management Corp.,* 44 SEC 442, 447 (1970). We recognize that both statements came after cessation of the conduct here complained of, but the proposition needed no elucidation. *See also Moses* v. *Burgin, supra,* 445 F.2d at 376 n.11. It is no answer for petitioners to contend that they were in no position to police IOS' exercise of its fiduciary responsibilities; they still were under no obligation to engage in conduct aiding IOS's fraud on the funds.

Starting from this position, we shall consider petitioners' various attacks on the Commission's conclusions.

(1) Petitioners say that, as a practical matter, they were compelled to apply the NYSE minimum rate

commission schedule on OTC transactions. Conceding that Article XV of the NYSE Constitution applied and legally could apply only to transactions on that exchange, they contend that NYSE looked with suspicion on the charging of lower rates on OTC transactions since such rates, at least if below cost, might operate in practical effect as a rebate of a portion of the commissions charged the same customer on NYSE business. They point to evidence that in fact NYSE would require a member that charged less than NYSE minimum commissions on OTC business to provide cost justification and contend that, as a new member operating a complex and costly trans-Atlantic communications network, it could not have satisfied NYSE that lower commissions on IOS generated OTC transactions were cost justified.

We need not debate the solidity of the factual basis for the argument. Whatever force petitioners' contention might or might not have if Lipper Corp. had retained the full commissions on OTC business and the complaint was that this amounted to a gouging of the funds, this was not what occurred. In fact Lipper Corp. did just what it claims NYSE prevented it from doing, namely, conduct OTC business at less than NYSE commission rates. Give-ups to the manager of an investment company on OTC transactions infringed the NYSE policy that members should not compete for business on a price basis as much—or as little—as the charging of lower commissions or give-ups to the investment company itself would have done. As the Commission said:

> The Lipper respondents claim to have been in fear of disciplinary action by the New York Stock Exchange. But they have never explained why this fear did not restrain them from giving

> up to IPC. If the New York Stock Exch
> rules had been applicable to these transac
> they would have prohibited commission
> ting with IPC as well as with the fund
> paid those commissions.

Putting the matter in another way, petitioners
duct either violated the spirit of the NYSE C
tution or it did not. If it did, they can deri
comfort from the argument that their acts were
pelled by the NYSE Constitution; if it did not,
likewise gain no protection.

In any event, no NYSE practice could imm
conduct assisting investment company managers
tively to pocket give-ups when the funds r
nothing in return.

(2) Petitioners argue that even though thei
duct might have violated Rule 10b–5 if the three
had been registered investment companies, a d
ent conclusion is compelled because here the pa
of give-ups to the manager was at the expen
off-shore funds, only one of which had Ame
shareholders. The argument ignores that the
charged by the SEC was perpetrated in the U
States by payments from one registered broker-d
(Lipper Corp.) to another (IPC) in connection
the purchase and sale of securities in the U
States over-the-counter market. We said in *I*
Vencap, Ltd., supra, 519 F.2d at 1017:

> We do not think Congress intended to
> the United States to be used as a base for
> ufacturing fraudulent security devices
> export, even when these are peddled on
> foreigners.

Petitioners thus derive no support from so mu
the decision in *Bersch* v. *Drexel Firestone, Inc., s*

519 F.2d at 992, as held that merely preparatory activity or non-feasance in the United States was not sufficient to trigger application of the securities laws in a class action for damages in the absence of effect on Americans. Also, in light of its language and our previous decisions, notably *Schoenbaum* v. *Firstbrook,* 405 F.2d 200, 207–08 (2 Cir. 1968), *modified in other respects,* 405 F.2d 215 (*en banc*), *cert. denied,* 395 U.S. 906 (1969), no discussion is needed to demonstrate the inapplicability of § 30(b) of the Securities Exchange Act, 15 U.S.C. § 78dd(b), which exempts "any person insofar as he transacts a business in securities without the jurisdiction of the United States." Petitioners argue that characterizing the transaction as a fraud on the funds may displace otherwise applicable foreign law, since certain countries in which IOS and its affiliates operate would allow the manager of an investment company to receive a commission for placing an order, in addition to the commission payable to the broker executing it. We do not think the result should differ on this account. Presumably the receipt of such commissions would have had to be reported by IOS and would thus have been known to existing shareholders of the funds and to persons solicited to buy their shares. Here IOS, through IPC, secretly pocketed the money. Moreover, we see no reason why the United States may not prescribe a rule for conduct within its border even if another country having an interest might be less rigorous. *See Bersch* v. *Drexel Firestone, Inc., supra,* 519 F.2d at 985; Restatement of the Foreign Relations Law of the United States § 17 (1965).

(3) Little need be said in regard to petitioners' contention that the arrangements for the payment of rebates to IPC were adequately disclosed. Admittedly

no disclosure was made directly to the boards of directors of IIT and Regent; the disclosure to the board of FOF was only that the arrangements were proper, with no attempt by independent directors to check this. Petitioners contend they could not compel disclosure; perhaps not, but here again they were under no obligation to engage in conduct that would be fraudulent without it. Moreover, it is not within the competence of a board of directors of an investment company to sanction the perpetration of a fraud by the manager. *Cf. Schoenbaum* v. *Firstbrook, supra,* 405 F.2d at 219–20; *Drachman* v. *Harvey,* 453 F.2d 722, 736–38 (2 Cir. 1972) (*en banc*). Indeed, it would seem that only a unanimous shareholder vote could ratify a fraud of this type even if approved by directors. See Ballentine on Corporations § 71, at 177 (rev. ed. 1946); Cary, Cases and Materials on Corporations 591–92 (1969); Lattin, Jennings & Buxbaum, Corporations 821 (1968 ed.); *Keenan* v. *Eshelman,* 23 Del. Ch. 234, 2 A.2d 904 (Sup. Ct. 1938); *Continental Securities Co.* v. *Belmont,* 206 N.Y. 7 (1912). An arrangement like that here at issue, which was a bald diversion to the manager of sums belonging to the investment company, is quite different from the situation in *Moses* v. *Burgin* and *Fogel* v. *Chestnutt,* where there were some arguable reasons against seeking recapture so that a negative decision by the board of directors, after full disclosure to the independent directors and approval by them and their colleagues, might protect an adviser from liability, under the business judgment rule. *See Fogel* v. *Chestnutt, supra,* 533 F.2d at 750.

(4) We find it convenient to treat together petitioners' arguments on the scores of scienter, willfulness and reliance on the advice of counsel.

It would seem at first blush that since the relevant provisions of § 15 of the Securities Exchange Act require a showing of willful violation or willful aiding and abetting, little would have been added by the recent holding in ***Ernst & Ernst*** v. ***Hochfelder,*** 425 U.S. 185 (1976), that "scienter" is a necessary element to establish liability in an action for damages under Rule 10b–5. However, "the Commission has consistently held under § 15(b) that the term ["willfully" in § 15] does not require proof of evil motive, or intent to violate the law, or knowledge that the law was being violated. . . . All that is required is proof that the broker-dealer acted intentionally in the sense that he was aware of what he was doing." 2 Loss, Securities Regulation 1309 (1961). This view has been accorded judicial acceptance. As this court said in *Tager* v. *SEC,* 344 F.2d 5, 8 (2 Cir. 1965):

> It has been uniformly held that "willfully" in this context means intentionally committing the act which constitutes the violation. There is no requirement that the actor also be aware that he is violating one of the Rules or Acts.[5]

Petitioners are thus right in contending that it is important to determine what standard of culpability *Hochfelder* imposes for a violation of Rule 10b–5 such as that here alleged, and specifically what the proper standard is in a disciplinary proceeding.

The *Hochfelder* plaintiffs sought to hold Ernst & Ernst, an international accounting firm, liable as an aider or abettor of one Leston B. Nay, president of First Securities Company of Chicago, a small broker.

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[5] The court cited, in addition to the Loss treatise, *Gilligan, Will & Co.*, 267 F.2d 461, 468 (2 Cir.), *cert. denied*, 361 U.S. 896 (1959), and *Hughes* v. *SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949).

Nay had induced the plaintiffs to invest in allegedly high-paying "escrow accounts" which he immediately converted to his own use. The accounts did not appear in First Securities' books and records, payment having been made by personal checks payable to Nay or to a designated bank for his account. In urging that Ernst & Ernst was liable as an aider and abettor, plaintiffs "specifically disclaimed the existence of fraud or intentional misconduct," 425 U.S. at 190. The claim was that Nay had imposed a "mail rule" that no mail addressed to him or to First Securities to his attention could be opened by anyone other than Nay, even if it arrived in his absence; that if Ernst & Ernst had conducted a proper audit, they would have discovered the existence of this rule; that Ernst & Ernst should then have disclosed the rule, in reports to the SEC, as an irregular procedure that prevented an effective audit; and that this would have led the SEC to make an investigation of Nay that would have revealed his fraudulent scheme. The Supreme Court held that a mere claim of negligence did not suffice to support an action for damages under Rule 10b–5 but that "scienter" must be alleged and proved.[6] Since plaintiffs had claimed nothing more than negligence, the Court had no occasion to refine its definition of *scienter* beyond saying that the term "refers to a mental state embracing intent to deceive, manipulate, or defraud" and leaving open the question whether reckless behavior would suffice to meet that test, 425 U.S. at 194 fn. 12.

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[6] The Court left open "the question whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b–5." 425 U.S. at 194 n.12. The Court said nothing about whether scienter is a necessary element in disciplinary actions

Putting aside for the moment the defense of reliance on the advice of counsel, we do not regard the *Hochfelder* decision as carrying the day for petitioners. The Court held that in order to create liability for damages under Rule 10b-5—and we assume in petitioners' favor that the same standard governs proceedings under § 15, *see* fn. 6—there must be proof of intention "to deceive, manipulate, or defraud"—not an intention to do this in knowing violation of the law. The Court reasoned that the language of § 10 suggested that the section "was intended to proscribe knowing or intentional misconduct," 425 U.S. at 197.[7] It thought that use of such words as "manipula-

under § 15. These actions share with damage suits the quality of visiting serious consequences on past conduct, even though they also have a remedial effect. They thus differ from injunctive proceedings, the objective of which is solely to prevent threatened future harm, although unlawul conduct is necessary—if not always sufficient—to demonstrate the reality of this threat. We therefore assume, *arguendo*, without deciding, that the *Hochfelder* culpability standard applies in disciplinary proceedings. Cf. Jaffe, Judicial Control of Administrative Action 267-68 (1965) ("Revocation, indeed, seems often to be used as a sanction not so much to control the respondent as to warn others, and thus it has a significant 'penal' component, even though the courts may choose to mask its character by calling it a 'civil' remedy.") (footnote omitted).

[7] Indeed even in the criminal context neither knowledge of the law violated nor the intention to act in violation of the law is generally necessary for conviction. The first proposition seems implied by the rule *ignorantia juris non excusat.* Hall, Criminal Law 288 (2d ed. 1961). And the second, of course, follows from the first. Perkins, Criminal Law 745 (2d ed. 1969). See ALI, Model Penal Code §§ 1.13(12), 2.02(2)(a) & (b); *Ellis* v. *United States*, 206 U.S. 246, 257 (1907), where, in rejecting a claim that knowledge of the law was required for conviction under a statute that included the word "intentionally", Justice Holmes said, "If a man intentionally adopts certain conduct in certain circum-

tive," "device," and "contrivance" made "unmistakable a congressional intent to proscribe a type of conduct quite different from negligence," 425 U.S. at 199. And it referred, 425 U.S. at 202, to the oft-cited testimony of a sponsor of the Act before the House Committee on Interstate and Foreign Commerce that what became § 10(b) says "Thou shall not devise any other cunning devices." While that phrase could not be regarded as including negligence, it reads precisely on what petitioners did here—charging the full NYSE commission rates on IOS generated OTC transactions and rebating half of these to IPC, a subsidiary of IOS, knowing that IPC would retain the sums paid to it although these should have been turned over to the funds directly or applied to reduce the advisory fee. It is no answer that petitioners may not have realized that this "cunning device" was a fraud.

We likewise reject petitioners' argument that there was no violation of Rule 10b–5 because they acted on the advice of their counsel, Mr. Conwill. We are not required to consider the Commission's arguments that the conduct was so flagrant a fraud that advice

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stances known to him, and that conduct is forbidden by the law under those circumstances, he intentionally breaks the law in the only sense in which the law ever considers intent." And see *Tager v. SEC*, *supra*, 344 F.2d at 8:

"We have recently held that a finding of actual knowledge is not necessary for finding criminal liability under § 24 of the Securities Act, 15 U.S.C. § 77x, for 'willful' violations of §§ 5(a) and (c) and 17(a), 15 U.S.C. §§ 77e(a), (c), and 77q(a). United States v. Benjamin, 328 F.2d 854, 863 (2 Cir.), cert. denied, 377 U.S. 953, 84 S.Ct. 1631, 12 L.Ed. 497 (1964). As Professor Loss reminds us, 'It is conceivable, therefore, that 'willfully' means something less in § 15(b) than it does in the penal provisions of the SEC acts. 2 Loss, [Securities Regulation] 1309. It is inconceivable that it means something more."

of counsel could never be a defense or, that such advice must be disregarded because Mr. Conwill informed petitioners that his advice ran counter to a position as to the illegality of give-ups on OTC transactions taken by the Commission's staff and indeed by the Commission in PPI. It is a sufficient answer that, with all respect for Mr. Conwill's knowledge and experience, he was not in a position to give petitioners wholly disinterested advice and petitioners could not have reasonably have thought he was. Although Cowett of IOS apparently was the architect of the plan here attacked, Conwill was counsel for IOS and his primary concern lay, as petitioners must have known, in promoting its interests by assisting Cowett. Petitioners say it was natural for them to turn to him, since he was so familiar with IOS's settlement with the SEC. But this familiarity could have been at the disposal of independent counsel retained by petitioners: alternatively petitioners could have retained Mr. Conwill and then had independent outside counsel check his advice. Petitioners also note that, in addition to being counsel for IOS, Conwill was a director of FOF so that they were justified in beliving that he was giving proper heed to the interests of the funds. We cannot regard the wearing of this additional hat as relieving Conwill of the interest he had as IOS' counsel in giving his sanction to an arrangement so advantageous to it. Petitioners' reliance on his advice goes not to the violation, but to the penalty.

(5) The points that initially gave us most concern were petitioners' claims that many other NYSE firms, including some of high reputation, made give-ups or conferred other benefits on NPC in connection with OTC transactions initiated by IOS and that the only

other firms disciplined in connection with IPC's receipt of give-ups, Hertz, Warner & Co. and Dishy, Easton & Co., together with certain principals, were only suspended from certain activities for short periods pursuant to settlement offers. Securities Exchange Act Releases No. 8874 and No. 8702. Petitioners' argument is not simply a protest against selective enforcement. They claim that the prevalence of the practice of customer-dealer give-ups on OTC transactions weighs heavily against the SEC's contention that it was a violation of law.

Examination of the record indicates that both the selective enforcement claim, to which in any event *Oyler* v. *Boles,* 368 U.S. 448, 454–57 (1962), would be a formidable obstacle, and the prevailing practice argument are considerably overstated. The record does demonstrate that other firms gave up to IPC in connection with OTC transactions. However, the exhibits prepared from IPC's books showing the corporation's receipt of reciprocal and directed income were not confined to OTC give-ups, and it seems indisputable that the activity of Lipper Corp. in this regard was far greater than that of these other firms. More important, in the view we take of the case, namely, that the SEC was not obligated to predicate liability on the broad basis that any OTC give-up was a *per se* fraud but could and did rely on the fact that petitioners made give-ups to IPC, knowing that this was an 80%-owned subsidiary of IOS and that no sales or research service was furnished in return, the evidence is much less significant. For nothing in the record shows that the other brokers who made OTC give-ups or conferred other benefits on IPC were aware of the latter facts. The evidence thus does not establish widespread belief in the legality

of what petitioners did—for whatever bearing that might or might not have. The effect of the evidence of widespread give-ups and other benefits to IPC on OTC business, like the advice of counsel defense, goes rather to the penalty.[8]

IV. Penalty

As stated, the ALJ repected the staff's recommendation that Lipper Corp.'s certificate of registration should be canceled and that Lipper should be barred and instead proposed a 12 month suspension, a period which expired in late October, 1976. The Commission adopted the staff recommendation.

Wright v. *SEC,* 112 F.2d 89 (2 Cir. 1940), might appear to be an obstacle to our altering the penalty chosen by the Commission. In *Wright,* review was sought of an SEC order expelling the petitioner from several national security exchanges and the court held

[8] Petitioners raise the point, made in their unsuccessful petition to the SEC for rehearing, that they were denied due process because although three of the four commissioners then in office heard oral argument on August 28, 1972, only one of these, Commissioner Loomis, joined in the decision of October 1975—the other three participants in the decision not having been members of the Commission in August 1972; petitioners, however, do not urge that we remand for additional oral argument because of this. Rule 21(f) of the Commission's Rules of Practice, 17 C.F.R. 201.21(f), allows a member who was not present at oral argument to participate in the decision on condition that he review the transcript of the argument, and it is not contended that this was not done. There is no general constitutional right to oral argument before an administrative agency. *FCC* v. *WJR*, 337 U.S. 265, 274–277 (1949), and the Commissioner's rule represents a reasonable accommodation of the interest—one almost essential in these days when many agency members serve so briefly. See *Gearhart & Otis, Inc.* v. *SEC*. 348 F.2d 798 (D.C. Cir. 1965).

that only one of the two findings of violation was justified. Still, a majority of the panel apparently thought that a reviewing court was "without power to supervise" the Commission's choice of sanction, although Judge Swan, the author of the opinion, disagreed:

> The petitioner urges that the order of expulsion is unduly harsh; that an order of suspension would have accorded investors all the protection they need. So far as appears this was Wright's first infraction of the statute. For many years he has been operating in Wall Street and his transactions in Kinner stock are the only blemish upon his reputation. There is nothing to indicate that he is an habitual manipulator or would be likely to try to manipulate the market in the future. To deprive him for all time of an opportunity to pursue his calling in a lawful manner does seem severe. But a majority of the court hold the view that we are without power to supervise the Commission's discretionary determination that expulsion of the petitioner is necessary and appropriate for the protection of investors. The writer of this opinion does not share that view, believing that under the power conferred upon this court to "modify", as well as to affirm or to set aside an order in whole or in part, we may reduce the relief accorded investors. My own opinion is that the Commission should be directed to reduce it.

112 F.2d at 95–96.[9]

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[9] The court then remanded to the Commission for its reconsideration of the penalty in view of the holding that one of the alleged violations was insufficiently shown. See 112 F.2d at 96. On remand, the Commission adhered to its determination of expulsion. *In the Matter of Charles C. Wright*, 12 SEC 100 (1942), and this was upheld on further review, *Wright* v. *SEC*, 134 F.2d 733 (2 Cir. 1943).

Numerous cases in this circuit since *Wright*, however, while not expressly repudiating that decision, have assumed that Commission-ordered penalties are reviewable as to severity although none apparently considered the sanction under review so harsh as to require that it be set aside. *See, e.g.*, *Berko* v. *SEC*, 316 F.2d 137, 141–42 (1963); *Tager* v. *SEC*, 344 F.2d 5, 9 (1965); *Hanly* v. *SEC*, 415 F.2d 589, 598 (1969); *Fink* v. *SEC*, 417 F.2d 1058, 1060 (1969); *Gross* v. *SEC*, 418 F.2d 103, 107 (1969); *Sinclair* v. *SEC*, 444 F.2d 399, 402 (1971). See also *Boruski* v. *SEC*, 289 F.2d 738 (1961); *Nassau Securities Service* v. *SEC*, 348 F.2d 133, 136 (1965).[10] Compare *Jacob Siegel Co.* v. *FTC*, 327 U.S. 608, 612 (1946). Reviewability of sanctions would seem to be authorized by application of the Administrative Procedure Act, see 5 U.S.C. §§ 551(10) & (13), 702, 706, the enactment of which adequately explains why *Wright's* suggestion that an agency's discretionary choice of sanctions cannot be altered has not been followed.[11] See also Jaffe,

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[10] Courts in other circuits similarly have reviewed SEC sanctions on an abuse of discretion or arbitrary or capricious standard. See, e.g., *Nees* v. *SEC*, 414 F.2d 211, 217 (9 Cir. 1969); *O'Leary* v. *SEC*, 424 F.2d 908, 912 (D.C. Cir. 1970); *Beck* v. *SEC*, 430 F.2d 673 (6 Cir. 1970) (setting aside four month suspension as a "gross abuse of discretion"); *Quinn & Co.* v. *SEC*, 452 F.2d 943, 947 (10 Cir. 1971), *cert denied*, 406 U.S. 957 (1972). See also *American Power Co.* v. *SEC*, 329 U.S. 90, 112–13 (1946), where the Court stated that an SEC remedial action would be set aside "only if the remedy chosen is unwarranted in law or is without justification in fact," a standard more recently applied to the review of an administrative sanction in *Butz* v. *Glover Livestock Comm'n Co., Inc.*, 411 U.S. 182 (1973).

[11] Indeed, the Commission does not contend here that the order is any sense unreviewable, urging instead that judicial disturbance of such orders is limited to cases of abuse of discretion. Respondent's Br. at 63.

Judicial Control of Administrative Action 270–71 (1965) ("It is not in accord with current concepts of justice that the exercise of such drastic powers [to revoke or suspend a license] should be totally beyond revision, particularly where exercised by our monolithic, policy-oriented agencies."); Schwartz & Wade, Legal Control of Government 270 (1972) ("One of the limitations of the administrative expert is his tendency to single-mindedness and excessive zeal. The judges can stand apart from the tensions of the immediate case and mitigate the enthusiasm of the expert by the community's sense of justice."). Given our power to review SEC penalty determinations, our authority to limit such sanctions in appropriate cases seems necessarily to follow.

Coming then to the question of the appropriateness of the Commission's sanction, we think it was too severe.[12] Clearly it is unnecessary to prevent petitioners from again doing what they did, since all customer-directed give-ups have been abolished since December 5, 1968. The purpose of such severe sanctions must be to demonstrate not only to petitioners but to others that the Commission will deal harshly with egregious cases. Viewed in bald outline and in the light of hindsight, petitioners' conduct may indeed seem egregious. But, as conceded by the Commission in an *amicus* brief filed in this court in *Tannenbaum*

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[12] Under the circumstances of this case we give little weight to the Commission's protestations that persons once barred might be readmitted to the securities business under proper supervision. See *Tager* v. *SEC*, supra, 344 F.2d at 9. Whatever the force of this in the case of a registered representative, Lipper is hardly interested in returning to the business as a minor salesman in a large brokerage firm. Moreover, eight years have already elapsed since the conduct of which the SEC complains.

v. *Zeller,* No. 75–7503, the years 1967 and 1968 in which petitioners engaged in unlawful give-ups were years of considerable uncertainty as to the regulatory climate concerning give-ups; the Commission was torn between its desire to move away from uniform fixed commission rates, a movement which would eliminate the economic basis for customer-directed give-ups, and its belief that existing give-up opportunities should be utilized by investment advisers for the benefit of shareholders in mutual funds. True, there was nothing in all this that should have induced a belief that give-ups could be utilized for the benefit of the adviser rather than of the fund. Still petitioners were living in a world of customer-directed give-ups, which many other competing brokers were directing to IPC. Moreover, they did act under the supervision of experienced although in our view not disinterested counsel and, while they knew exactly what they were doing, there is no evidence that they had any thought they were violating the law—unless, of course, it were the law that any give-up on OTC business was fraudulent, which they had been advised, perhaps correctly, was not true. We are moved also by the inordinately long time in which this proceeding has been pending, particularly the unexplained lapse of over three years from the argument to the decision of the Commission, the cloud that has hung over petitioners' heads during this period and the tremendous disparity between the sanctions invoked against petitioners and that imposed on two other brokers whose violations were perhaps more clear. Finally, although the Commission is in no way bound by the views of the ALJ, *FCC* v. *Allentown Broadcasting Corp.,* 349 U.S. 358 (1955); *Hiller* v. *SEC,* 429 F.2d 856, 858 (2 Cir. 1970), some weight may properly be given to his opportunity

to observe Lipper and others who played a part in the acts here in question and in fashioning a remedy in light of that observation. *Universal Camera Corp.* v. *NLRB,* 340 U.S. 474, 492–97 (1951). If this statute authorized suspension for a period longer than twelve months, and the Commission had exercised such authority to suspend for say another twelve months, we surely would not interfere. But with the choices limited to a suspension of not more than twelve months or a revocation or bar, we consider that, under the special circumstances of this case, selection of the latter was an abuse of discretion.

The petition to review is therefore denied except that the sanctions shall be limited to suspension of Lipper Corp.'s registration for 12 months from the date of the Commission's order and the barring of Lipper from association with any broker or dealer for the same period.

APPENDIX B

United States Court of Appeals, Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the tenth day of December, one thousand nine hundred and seventy-six.

Present: Hon. Henry J. Friendly, Hon. Paul R. Hays, Hon. William H. Mulligan, *Circuit Judges.*

76–4067

Arthur Lipper Corporation and Arthur Lipper, III, petitioners

v.

Securities and Exchange Commission, respondent

A petition for review of orders of the Securities and Exchange Commission

This cause came on to be heard on a certified list of items comprising the record of the Securities and Exchange Commission and was argued by counsel

Upon consideration thereof, it is now hereby ordered, adjudged and decreed that the petition be and it hereby is denied except that the orders be and they hereby are modified in accordance with the opinion of this court.

A. Daniel Fusaro,
Clerk,
by: Vincent A. Carlin,
Chief Deputy Clerk.

APPENDIX C

United States Court of Appeals, Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the twenty-second day of March, one thousand nine hundred and seventy-seven.

Present: Hon. HENRY J. FRIENDLY, Hon. PAUL R. HAYS, Hon. WILLIAM H. MULLIGAN, *Circuit Judges.*

76–4067

ARTHUR LIPPER CORPORATION AND ARTHUR LIPPER, III,
PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

A petition for a rehearing having been filed herein by counsel for the respondent (Securities and Exchange Commission)

Upon consideration thereof, it is

Ordered that said petition be and hereby is Denied.

A. DANIEL FUSARO,
Clerk.

APPENDIX D

ARTHUR LIPPER CORPORATION AND

ARTHUR LIPPER, III, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION, RESPONDENT

No. 165, Docket 76–4067.

United States Court of Appeals, Second Circuit

Petition for Rehearing Dec. 27, 1976

Order Denying Petition for Rehearing

March 22, 1977

Dissenting Opinion April 1, 1977

A petition for rehearing containing a suggestion that the action be reheard en banc having been filed herein by counsel for the respondent, and a poll of the judges in regular active service having been taken and there being no majority in favor thereof,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

OAKES, Circuit Judge (with whom Judge MESKILL concurs):

I dissent from the denial of rehearing en banc. Expressing no opinion on the merits, it seems to me that this case raises sufficiently important questions of administrative law and the role of the courts therein,

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of general applicability, to warrant our careful consideration sitting en banc. Even assuming as the panel opinion persuasively argues, that *American Power & Light Co.* v. *SEC,* 329 U.S. 90, 112, 67 S.Ct. 133, 91 L.Ed. 103 (1946), and *Butz* v. *Glover Livestock Commission Co.,* 411 U.S. 182, 93 S.Ct. 1455, 36 L.Ed.2d 142 (1973), permit the reviewing court to vacate an administrative sanction, which is " 'peculiarly a matter for administrative competence,' " 329 U.S. at 112, 67 S.Ct. at 146, it is difficult to see how the reviewing court may properly substitute its judgment for that of the agency on such a matter. *O'Leary* v. *SEC,* 137 U.S.App. D.C. 420, 424 F.2d 908, 911–12, (1970); see K. C. Davis, *Administrative Law Treatise* § 30.10, at 250–52 (1958). Underlying precepts of administrative law would seem to require a remand for further agency consideration of the sanction if it has previously abused its discretion. I am as intolerant of the agency's delays in this case, and other agencies' in other cases, as the distinguished author of the majority opinion, but I question seriously whether those delays justify taking a leap which has, except for one "sport," *Beck* v. *SEC,* 430 F.2d 673 (6th Cir. 1970) (entire sanction set aside), not heretofore been taken, that is, the reviewing court's substituting its own judgment of what the sanction should be for that of the agency. *See, e.g. Hanly* v. *SEC,* 415 F.2d 589, 598 (2d Cir. 1969); *Marketlines, Inc.* v. *SEC,* 384 F.2d 264, 267 (2d Cir. 1967), *cert. denied,* 390 U.S. 947, 88 S.Ct. 1033, 19 L.Ed.2d 1137 (1968). If this is the unique case the panel opinion pictures it as—where the SEC had absolutely no choice under the statute, Section 15(b)(4), (6) of the Securities Exchange Act, 15 U.S.C. § 78o(b)(4), (6), between a

year's suspension and a permanent bar—it would be one thing, but it seems to me it was entirely open to the Commission to impose a bar with leave to reapply, just as this court recommended to the Drug Enforcement Administration in *Sokoloff* v. *Saxbe,* 501 F.2d 571, 576–77 (2d Cir. 1974). I fail to see any Commission rule or requirement that readmission to the business be under supervision or, if it were, that this would be so terribly unfair to someone who ignored his fiduciary obligations and violated the Securities Exchange Act and Rules thereunder.

APPENDIX E

SECURITIES EXCHANGE ACT OF 1934, Release No. 11773/
October 24, 1975

Admin. Proc. File Nos. 3–2156 and 3–2157

In the Matters of:

ARTHUR LIPPER CORPORATION, 140 Broadway, New
New York, New York (8–13182)

ARTHUR LIPPER, III, IOS, LTD. (S.A.), Geneva,
Switzerland

INVESTORS PLANNING CORPORATION OF AMERICA, (now known as CIP, Inc.) New York, New York (8–12374)

OPINION OF THE COMMISSION

BROKER-DEALER PROCEEDINGS

Grounds for Remedial Sanctions

Recapture by Affiliate of Commissions on Investment Company Portfolio Transactions Through Give-Ups from and Reciprocal Arrangements with Unaffiliated Broker-Dealers

Receipt of Money in Connection with Investment Company Portfolio Transactions

Over-the-Counter Give-Ups

Conflict of Laws—International Law

Where manager of unregistered off-shore investment companies selected to execute companies' over-the-counter portfolio transactions broker who paid portion of commissions on such business to manager's subsidiary, *held,* manager, aided and abetted by broker, violated Section 10(b) of the Securities Exchange Act and Rule 10b–5 thereunder; and gravity of misconduct required that registration of broker be revoked and that manager be barred.

Where Securities Exchange Act's antifraud provisions were violated in connection with portfolio transactions of unregistered off-shore investment companies executed in the United States, and where the violators were registered broker-dealers, *held,* United States has jurisdiction to take remedial action.

Receipt by Affiliate of Compensation in Connection with Purchase and Sale of Investment Company Property

Deficient Investment Advisory Contract

Misstatements in Prospectuses, Proxy Material and Other Documents

Where registered broker-dealer who was mutual fund's principal underwriter and investment adviser procured for itself rebates of fund's brokerage commissions from unaffiliated brokers without rendering any brokerage services in return therefor, *held,* such broker-dealer and its unregistered corporate parent violated or aided and abetted violations of Securities Exchange Act's antifraud provisions and of Sections 17(e)(1), 15(a)(1), 20(a), and 34(b) of the Investment Company Act and also of Rule 20a–1 under the Investment Company Act.

Appearances:

Allan F. Conwill, of Willkie, Farr & Gallapher, *John A. Dudley*, of Sullivan & Worcester, and *Howard S. Klotz*, for Arthur Lipper Corporation and Arthur Lipper, III.

Calvin H. Cobb, Jr., Robert M. Goolrick, Edmund B. Frost, and *W. John Amerling*, of Steptoe & Johnson, for IOS, Ltd. (S.A.) and Investors Planning Corporation of America.

Stanley Sporkin, Marvin E. Jacob, Robert M. LaPrade, Joanne Leveque and *Robert L. Anthony*, for the Division of Enforcement of the Commission.

I. INTRODUCTION

This case is about the once vast international financial complex controlled by IOS, Ltd. (S.A.) ("IOS").[1] More specifically, it is about IOS's handling of the large volume of brokerage business generated by the enormous pools of other people's money under its management and about the way in which IOS used that brokerage business to serve its own interests rather than those of the investors who had entrusted their savings to it. The transactions in question were executed in the over-the-counter market and on the New York Stock Exchange.

In 1967 and 1968, the period involved in this case, brokers executed all stock exchange orders at fixed rates. These rates varied with the price per share of the security. But the commission was calculated on a per share basis. The commission on an order for 10,000 shares of a given stock was exactly 100 times that on an order for 100 shares of the same stock. Brokers found it profitable and were eager to handle transactions for investment companies and other in-

[1] The initials stand for Investors Overseas Services.

stitutional customers because the cost of handling large orders did not increase proportionately with the commissions they were obligated to charge. This was so much the case that brokers were willing and anxious to execute large institutional orders for substantially less than the fixed minimum commission rate. Since the commission could not be reduced, brokers were willing, at the customer's direction, to pay over part of the commission to other brokers within the rules of the stock exchange. Thus, large institutional investors had substantial amounts of so-called "excess brokerage" (i.e., that portion of the commission that the executing broker was willing to give up) at their disposal.[2]

II. THE ADMINISTRATIVE LAW JUDGE'S INITIAL DECISIONS

The administrative law judge before whom the hearings were held concluded that:

1. Brokers who executed transactions for, and who therefore received commissions from, members of the complex of mutual funds managed by IOS[3] surrendered portions of those commissions to an IOS subsidiary known as Investors Planning Corporation of

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[2] In theory, only the minimum rate of commissions was fixed. Brokers were free to go higher if they wished. And, in fact, brokerage houses sometimes charged more than the minimum on small transactions or even refused to handle them at all. By and large, the minimum was also the maximum.

[3] A group of mutual funds under common management is called a "fund complex." *See Report of the SEC on Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess., 45–47 (1966) [hereinafter cited as Public Policy]. *See also* Glazer, *A Study of Mutual Fund Complexes*, 119 U. Pa. L. Rev. 205 (1970).

America ("IPC").[4] This was done at IOS's direction.

2. Neither IOS nor IPC[5] rendered any brokerage services to the funds in whose commission disbursements they shared.

3. The money surrendered by the executing brokers to the IOS respondents belonged in equity and good conscience to the funds out of whose commissions it came. When the IOS respondents appropriated that money for themselves, they breached their fiduciary duties to the funds under their management. This breach of duty and the failure to disclose it to actual and prospective investors in those funds were in willful violation of Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.

4. Fund of America, Inc. ("FOA") was registered with us as an investment company under the Investment Company Act. When the IOS respondents took a portion of that fund's excess brokerage, they violated various provisions of the Investment Company Act.

5. The IOS respondents' violations were serious. It is in the public interest to bar IOS itself from association with a broker or dealer. But IPC's situation is different. It is no longer controlled by or affiliated with IOS. Since its wrongdoing stemmed from its former relationship to IOS, a nine-month suspension of IPC's broker-dealer registration is enough to satisfy the public interest.

6. Arthur Lipper Corporation ("Lipper Corp."), a New York City broker-dealer, and, during the rele-

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[4] IOS owned eighty percent of the outstanding IPC stock. After the events dealt with in this opinion, IPC changed its name to CIP, Inc.

[5] Hereinafter sometimes referred to collectively as "the IOS respondents."

vant period, a New York Stock Exchange member firm and also a member firm of other domestic securities exchanges registered with this Commission under the Securities Exchange Act, was organized to handle the large brokerage business for IOS-managed funds. Substantial portions of the commissions received from such business were surrendered to IPC. Thus, the Lipper firm was a knowing participant in the IOS respondents' fraudulent scheme. And so was its founder, president and controlling stockholder, Arthur Lipper, III. Lipper and his firm [6] willfully aided and abetted some of the IOS respondents' violations of Section 10(b) of the Exchange Act and Rule 10b–5 thereunder.

7. It would be in the public interest to suspend the Lipper firm from effecting transactions in the over-the-counter market for twelve months. During that period, Lipper himself should be suspended from association with any broker or dealer.

An independent review of the record leads us to agree with the administrative law judge's analysis.[7] We are also in accord with his view that it is in the public interest to preclude IOS from associating itself with brokers or dealers in the future. But we see no need at this juncture for remedial action against IPC. And we also disagree with the administrative law judge about the nature of the sanctions against the Lipper respondents called for by the public interest.

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[6] Hereinafter sometimes referred to collectively as "the Lipper respondents."

[7] The respondents petitioned for review of the administrative law judge's decision. Our Division of Enforcement also sought review with respect to what it considers the gross inadequacy of the sanctions imposed on the Lipper respondents. After granting all of the petitions for review we received briefs from all parties and heard oral argument.

As to that, we agree with our staff that suspension is not enough and that the Lipper respondents ought to be barred from the securities business.

Our reasons for so holding are stated below.

III. THE IOS COMPLEX

During the 1950's and the 1960's, the basic trend in the American equity securities markets was upward. In those years, the American mutual fund industry grew dramatically.[8] These developments led foreign investors to take a favorable view of American mutual funds, and facilitated the sale of their shares abroad. IOS capitalized on this market.[9] It did so by means of the so-called "off-shore fund." That involved the formation by IOS of investment companies in countries other than the United States.[10] Those entities sold their shares outside the United States. But they invested the proceeds largely or wholly in United States securities, using our securities markets to do so. IOS created off-shore funds, managed them after their creation, and sold their shares in many countries.

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[8] This theme was expounded at length in Public Policy.

[9] IOS's first idea was the fund holding company. The Fund of Funds ("FOF") formed for the purpose of investing in American mutual funds registered and regulated under the Investment Company Act and in publicly-held mutual fund management companies. *See Public Policy* 311–324. But by the time dealt with in this opinion the original concept had been broadened so that it included direct investment in the stocks and bonds of United States companies engaged in industry and trade.

[10] The name "off-shore" is said to reflect the fact that many of the funds were set up on the islands off the shores of the United States. Note, *United States Taxation and Regulation of Offshore Mutual Funds*, 83 Harv. L. Rev. 404, 405 n. 10 (1969).

During the period of concern to us here, IOS, a Panamanian corporation that maintained its principal offices in Switzerland, controlled IPC, a large New York City-based United States broker-dealer registered as such under the Exchange Act. IPC had little or no general securities business. Its primary activity was the retail sale of mutual fund shares to Americans here in the United States. Like many other mutual fund retailers, IPC sold the public shares in many different mutual funds. But it had nothing whatever to do with the management of those funds.

IPC, however, was more than a mere retailer of shares in mutual funds that were managed by others. It also had its own "in-house" fund for which IPC acted as investment adviser and principal underwriter. This fund was FOA, corporation organized under New York law. There was nothing "off-shore" about FOA. It was just another domestic mutual fund. Like hundreds of similar funds, it was subject to the Investment Company Act and registered with us under that statute as an open-end investment company.

IPC's domestic mutual fund retailing operation was much older than IOS. In April 1965, IOS bought a controlling interest in IPC's going (albeit then unprofitable) retail mutual fund business.[11] After that,

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[11] IOS attributed the losses to IPC's "unimaginative" management. An IOS official testified that IPC was acquired because it "represented an opportunity for IOS to come into the United States market, building from a base of a reasonably large and well-established broker-dealer." IPC had a 5,000-man sales force at the time of its acquisition by IOS. It appears that this sales force consisted for the most part of what a study by the staff of our Office

IOS naturally wanted to make IPC profitable. One way of doing this was to build up IPC's captive fund, FOA.

As a mere merchandiser of shares in mutual funds controlled by others, IPC could expect only the retail dealer's share of the sales charge plus some excess brokerage income funneled to it by the managers of the funds whose shares it was selling. But when IPC sold shares in FOA, it:

1. Kept the total sales charge since there was no unaffiliated wholesaler or principal underwriter with whom that charge had to be divided;[12] and

2. Enhanced its advisory fee income because the sale of new shares increased the volume of assets on which the fee paid to IPC by FOA was based.[13]

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of Economic Research described as "armies of salesmen who are believed to be worthwhile even if they only sell themselves, their close friends, and their relatives." SEC Staff Report *On the Potential Economic Impact of a Repeal of Section 22(d) of the Investment Company Act of 1940*, p. A-49 (November 1972). *See also id.* at pp. A-63–A-64 (referring to "legions of unproductive low-income salesmen").

[12] Mutual fund sales charges tended to cluster around the 8.5 percent level. Thus, when an investor wrote a check for a thousand dollars to pay for a purchase of "load" fund shares, only $915 of that sum actually went to the fund for investment. The other $85 was consumed by the sales charge, which went to those who made the sale. During the relevant period, it was usual for principal underwriters to retain two percent of the investor's total payment (or about 25 percent of the aggregate sales charge) for themselves. The balance went to the retail dealers and the salesmen who did the actual selling. Public Policy 207–209.

[13] Over the long-run, this was much more important than sales charge revenues. Generally, the advisory fees that the adviser-underwriters receive for their managerial services are based on the size of the asset pools under management. Since the size of a mutual fund does not fluctuate nearly as much as the sale of new shares, the advisory fee provides a stable source of income.

So IOS made FOA grow.[14] It did that in two ways. First, it caused IPC's sales force to push FOA and to deemphasize what had theretofore been that sales force's primary pursuit, the sale of shares in mutual funds unaffiliated with IPC. Second, IOS put money from one of its own offshore funds into FOA. IOS's foreign mutual fund holding company, FOF,[15] bought into FOA in a big way. From July 1965 to August 1966, FOF invested approximately $22 million in FOA. By mid-1966, FOF owned about 46 percent of FOA's outstanding shares.[16]

FOF's investment in FOA was a highly-remunerative proposition for IOS. The benefits to FOF itself or its shareholders were more obscure, to say the least. By having one of its funds, FOF, invest in FOA, another IOS-managed fund, IOS:

1. Collected a sales charge on a sales charge—because the investor who bought FOF shares and who paid a sales charge to IOS at that time also bore the burden of the sales charge later paid by FOF to IPC (but inuring, of course, to the benefit of IPC's parent, IOS) when FOF purchased FOA shares from IPC, the exclusive distributor of those shares;[17] and

2. Received two advisory fees out of what was in economic reality a single pool of capital—IOS took

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[14] FOA had only about $5 million in assets when IOS came into the picture. A year and a half later (on November 30, 1966) FOA's assets were around $44 million.

[15] *See* n. 9 on p. 5, *supra*.

[16] Public Policy 313, Table VIII–1. The record shows that in January 1968 FOF still owned approximately 40 percent of FOA's shares.

[17] There were so many entities in the IOS complex that the above text simplifies the corporate relationship involved. FOA's underwriter was IPC, and FOA's adviser was IPC's wholly-owned subsidiary, Fund of America Management Corporation.

an advisory fee from FOF in exchange for its services in putting FOF's money into FOA, and through IPC it then took a second advisory fee from FOA for managing FOA's investments.[18]

IV. THE 1966 PROCEEDING AND ITS AFTERMATH

Soon after IOS's acquisition of IPC, members of the Commission's staff reported to the Commission that information had come to their attention indicating that IOS's assertedly off-shore funds were not wholly off-shore. Our staff believed that shares in those funds had been offered and sold to an appreciable numbers of Americans fraudulently and in violation of the Securities Act's registration requirements.[19] To determine whether this was actually so and what remedial action, if any, was needed, this Commission, in February 1966, instituted an administrative proceeding against IOS and some of its affiliates.[20] After the failure of its strenuous efforts to enjoin that proceeding on the ground that we had no power to conduct it,[21] IOS decided to settle.

During settlement negotiations with our staff, IOS learned that settlement would require a material reduction in the scope of its United States activities.

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[18] As we said in Public Policy: "Inherent in the fund holding company structure is a layering of costs including advisory fees, administrative expenses, sales loads, and brokerage fees, all of which serve to make a fund on funds a particularly expensive investment vehicle." Public Policy at 318.

[19] Our staff also believed that violations of the Investment Company Act had been committed.

[20] Administrative Proceeding No. 3-497 instituted by order of February 3, 1966. This proceeding is referred to as "the 1966 proceeding."

[21] *See Fontaine* v. *SEC*, 259 F. Supp. 880 (D.P.R., 1966).

IOS made an offer of settlement in which it undertook, among other things, to:

1. Divest itself of IPC within a specified time:
2. Cease selling securities to United States citizens and nationals wherever located, except, *inter alia,* for sales by IPC during its continued ownership of that entity;
3. Make a rescission offer to Americans who held interests in FOF;
4. Withdraw its own broker-dealer registration and the registrations of those of its affiliates that were then registered with us as brokers and dealers; and
5. Conduct all of its securities activities outside the United States.

We accepted IOS's offer on May 23, 1967, thus terminating the 1966 proceeding.[22]

Before that time, IOS began to prepare for the day when it would have to dispose of IPC and place all orders for United States securities abroad through an independent foreign brokerage firm or through an independent United States brokerage firm with a foreign branch office. IOS chose Lipper as a broker for the funds managed by it. At IOS's instance, in March 1967 Lipper organized Lipper Corp., headquartered in New York, with branch offices in London and Geneva. He did so for the primary purpose of acting as a broker for the funds managed by IOS and after assurances from it of sufficient business from "IOS generated sources to cover the kind of investment involved."[23] The "investment involved"

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[22] *IOS, Ltd. (S.A.)*, Securities Exchange Act Release No. 8083.

[23] From April 1967 through June 1968, Lipper Corp. received gross commisisons of $11,372,000, $8,014,000 of which came from IOS-related business.

was needed to establish an elaborate communications network for transmitting the orders that the IOS-managed funds placed with Lipper Corp.'s foreign branches to its main office in New York. Through this network those foreign funds continued to buy and sell United States securities in this country's markets rather than in those abroad.

As for IPC, the settlement agreement granted IOS a period of time before it had to sell its shares of IPC, and this was ultimately accomplished in the fall of 1968. Of course, the price that IOS could expect to obtain for its IPC shares obviously depended on the latter's earning power. IOS, therefore, had an especially strong incentive to improve IPC's performance prior to the sale. The Lipper respondents helped IOS to attain that objective.

V. REBATES OF OVER-THE-COUNTER BROKERAGE COMMISSIONS

A. The facts and their legal consequences

Lipper Corp. handled the foreign funds' over-the-counter business on an agency basis. For its services in this regard, Lipper Corp. charged the stock exchange commission rate. But it kept less than half of the resulting gross commissions. The rest of them were paid over—"given up" in the jargon of the trade—to IPC. These give-ups by Lipper Corp. to IPC totaled about $1,450,000 from July 1967 to August 1968. In view of IOS's relationship to IPC, that money was for all practical purposes given up to IOS.

Since neither of the IOS respondents performed any brokerage function in connection with the over-the-counter transactions handled by Lipper Corp., it

is apparent that they did nothing in return for the income that they derived from those transactions.[24] They simply caused the funds to divert $1,450,000 to them. Lipper Corp. was a mere conduit for the diversion. No extended discussion is required to demonstrate that this was a gross breach of fiduciary duty by the IOS respondents.[25]

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[24] It is true, of course, that IOS managed the funds and that this involved work. But IOS was getting a management fee for these services.

[25] Investment advisers are fiduciaries. *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180, 191 (1963); *Arleen W. Hughes*, 27 SEC 629, 635–638 (1948), *aff'd sub. nom. Hughes* v. *SEC* 174 F.2d 969 (C.A.D.C., 1949). And investment advisers to investment companies are on the same footing. *Rosenfeld* v. *Black*, 445 F. 2d 1337 (C.A. 2, 1971), *petition for cert. dismissed* 409 U.S. 802 (1972); *Brown* v. *Bullock*, 194 F. Supp. 207, 229 (S.D.N.Y. 1961), *aff'd* 294 F.2d 415 (C.A. 2, 1961). *See Provident Management Corp.*, 44 SEC 442, 447 (1970: "Porteous and Lautsbaugh, as officers of Fund and as persons responsible for directing the execution of its portfolio transactions, and Management by virtue of its position as investment adviser, were fiduciaries of Fund. As such, they were under a duty to act solely in the best interest of Fund and its shareholders . . . . While there is no proof that Fund did not receive the best execution on its transactions, or that the existence of the arrangement described resulted in additional costs to Fund, once the reciprocal arrangements were made, it was improper for Porteous & Co. to keep for itself rather than confer on Fund the benefits attributable to Fund's assets."; *Consumer-Investor Planning Corp.*, 43 SEC 1096, 1100–1101 (1969): It is clear that [respondents] . . . placed the purchase and sale of the Fund's portfolio securities with those brokers who would pay over to them the largest extractable portions of the brokerage commissions thus generated and the most substantial other benefits. The payments and benefits received by them did not represent compensation for any services rendered to or benefits conferred upon the Fund, but rather constituted a form of personal enrichment derived from the Fund's portfolio transactions. By such bla-

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Such "disregard of trust relationships by those whom the law should regard as fiduciaries" was one of the evils that the Exchange Act sought to eliminate.[26] We therefore find, as did the administrative law judge, that the IOS respondents' over-the-counter commission-splitting arrangements were a fraud on the foreign funds and on their shareholders.[27] It

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tant trafficking of the Fund's business, respondents simply used their fiduciary positions in relation to the Fund to cause monetary and other benefits to inure to themselves without regard to what was best for the Fund . . . . The abuse of position and conflict of interests inherent in the making of these arrangements was clearly inimical to the Fund and its shareholders."; *Deleware Management Co.*, 43 SEC 392 (1967).

[26] H.R. Rep. No. 1383, 73d Cong., 2d Sess. 6 (1934).

[27] Respondents contend that their over-the-counter commission arrangements were disclosed to the directors of the foreign funds. Like the administrative law judge, we find this contention unsupported by the record. Three foreign funds were involved. The Lipper-IPC give-up arrangements are claimed to have been discussed at a meeting of one of the three boards. But what about the boards of the other two funds? No disclosures are expressly claimed to have been made to them. As to the disclosures made to the one fund, we agree with the administrative law judge that they cannot be deemed to have been adequate. But even if they had been adequate so far as the directors were concerned, it seems to us that in view of IOS's controlling influence over these entities, the disclosure required in this situation was disclosure to the shareholders actual and prospective. Moreover, the administrative law judge pointed out that the person making the purported disclosures was a principal in the scheme to defraud the foreign funds. *Cf. Schoenbaum* v. *Firstbrook*, 405 F. 2d 200, 211–212, *reversed in part on other grounds en banc* 405 F. 2d 215 (C.A. 2, 1968), *cert. denied sub nom. Manley* v. *Schoenbaum*, 395 U.S. 906 (1969): "In general, if the corporation's agents have not been deceived, neither has the corporation. However, as in other situations governed by agency principles, knowledge of the corporation's officers and agents is not imputed to it when there is a conflict between

follows that the IOS respondents willfully violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

Since the Lipper respondents knew about IOS's relationship to the foreign funds, and since their active assistance was an essential element of the scheme, they were clearly participants in the IOS respondents' breach of trust. It follows that the Lipper respondents willfully aided and abetted the IOS respondents' violations.[28]

Respondents advance various arguments, based upon then existing rules and practices in the securities markets which, they claim, justify their activities. To these we now turn.

Respondents claim that the rules of the New York Stock Exchange required the funds to bear over-the-counter brokerage costs that are conceded to have been high. They argue that:

1. As a New York Stock Exchange member, Lipper Corp. was bound to adhere to that organization's minimum commission rate schedule.

2. The anti-rebate rules that the exchange adopted for the purpose of preventing its members from cutting rates in underhanded ways precluded Lipper from returning any excess brokerage to the funds themselves.

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the interests of the officers and agents and the interests of the corporate principal. [Citations omitted.] Therefore, a corporation may be defrauded in a stock transaction even when all of its directors know all of the material facts, if the conflict between the interests of one or more of the directors and the interests of the corporation prevents effective transmission of material information to the corporation, in violation of Rule 10b-5(2)." *See also* *Pappas* v. *Moss*, 393 F.2d 865 (C.A. 3, 1968).

[28] *See Provident Management Corp.*, 44 SEC 442, 448 (1970).

3. There were only two choices. One was for Lipper to retain for himself all of the brokerage that the New York Stock Exchange had thrust into his unwilling hands. The other was to divide it with IOS. In no event could the funds' over-the-counter brokerage costs have been any lower than they actually were.

This argument, although perhaps superficially appealing, is, upon analysis, unavailing. The New York Stock Exchange had no jurisdiction over commission rates in over-the-counter transactions. The over-the-counter market during the relevant period was, and it still is, "a negotiated market . . . not governed by fixed prices or minimum commission rate schedules." [29] Therefore, "any willingness of the executing broker . . . to allow his customer to direct a give-up of a portion of his commission . . . in and of itself shows that a lower . . . commission could have been negotiated." [30]

The New York Stock Exchange's anti-rebate policies are clearly not relevant here. Those policies applied only to transactions on that exchange. What they prohibited was the division of commissions paid for such transactions with those who were not themselves members of the New York Stock Exchange.[31] The transactions involved herein were not New York Stock

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[29] Public Policy 178. Although the practice was to charge the New York Stock Exchange minimum rate on over-the-counter transactions executed on an agency basis, no rules legally binding on Lipper required this. A violation of the National Association of Securities Dealers' Rules of Fair Practice might have been involved, however, if the commission charged was in excess of the New York Stock Exchange minimum.

[30] Public Policy 178.

[31] Public Policy 170.

Exchange transactions.[32] Nor was IPC a New York Stock Exchange member. The Lipper respondents claim to have been in fear of disciplinary action by the New York Stock Exchange.[33] But they have never explained why this fear did not restrain them from giving up to IPC.[34] If the New York Stock Exchange's rules had been applicable to these transactions, they would have prohibited commission-splitting with IPC as well as with the funds that paid those commissions.

Moreover, the New York Stock Exchange had no jurisdiction over IPC. There is nothing in the record to show that the exchange would have been discon-

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[32] The New York Stock Exchange's vice president in charge of member firms testified that "The New York Stock Exchange minimum commission applied to New York Stock Exchange trades, not over-the-counter trades." The following colloquy then ensued:

"Q. To what extent does the New York Stock Exchange feel it has the authority to establish rates in the over-the-counter market?

A. We don't feel that we have any authority to establish rates in the over-the-counter market."

[33] The New York Stock Exchange official previously referred to did testify that very low over-the-counter charges might in certain circumstances be deemed impermissible rebates. But he made it clear that he was talking about over-the-counter commissions that were below the cost of doing business. He further testified as follows on redirect examination by Division counsel:

"Q. Now Mr. Bishop, is it a requirement of the New York Stock Exchange that the minimum New York Stock Exchange [sic] be charged by member firms in executing over-the-counter transactions, even though the minimum New York Stock Exchange Commission exceeds the cost of executing the transaction?

A. No."

[34] Lipper testified:

"Q. Weren't you concerned that the New York Stock Exchange might consider the payment of commissions earned in the over-the-counter market, for Fund of Funds portfolio transactions, to IPC, as violative of their anti-rebate rules?

A. No sir, I was not concerned."

certed had IPC returned Lipper's give-up money [35] to the funds.[36] Hence the administrative law judge was clearly correct when he held that:

"There was no requirement of the NYSE that its members charge NYSE rates on over-the-counter transactions and Cowett [IOS's executive vice president and the principal architect of the give-up scheme] and Lipper, both highly sophisticated in the financial world, knew or should have known the limitations of the NYSE rules. It was permissible for Lipper Corporation to charge less on the funds' over-the-counter transactions and, contrary to respondents' position, the record evidences a willingness by Lipper Corporation to be content with 50% of the amounts actually charged the funds on such transactions. In this connection, it is also clear from the record that Cowett was not interested in negotiating for a lower rate but in having Lipper Corporation give up 50% of the funds' commission payments to IPC so that the latter would obtain additional revenues."

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[35] During the relevant period, the New York Stock Exchange permitted one of its members to manage a large investment company complex without receiving any management fee. The partners in that firm viewed the brokerage income that they derived from the complex's portfolio transactions as sufficient in itself to compensate them for their services. There is no indication that the Exchange considered this arrangement an impermissible rebate. *See* Public Policy 106–109.

[36] Whatever the New York Stock Exchange's sentiments might or might not have been, the money having come from the funds in the first place, and IPC having done nothing to earn it, there was no way in which the ICS respondents could lawfully keep it. *Moses* v. *Burgin*, 445 F.2d 369, 376 n. 11 (C.A. 1, 1971), *cert. denied* 404 U.S. 994 (1971).

Respondents say that customer-directed give-ups were widespread and generally regarded as legitimate in 1967 and 1968. They are right about that. But their conclusion that this justifies the activities here involved, however, is unfounded because the customer-directed give-ups referred to, which were in the exchange market, differed from the present case in two critical respects. First, they did not involve fiduciaries diverting their beneficiary's funds into their own pockets. Secondly, they represented a form of competition for lucrative institutional business that prevailed under the rigid fixed commission rate system which existed in the exchanged markets only.

Exchange rules fixed minimum commissions at a rate which often exceeded the amount for which a broker was willing to execute a transaction. Exchange rules also prohibited any rebate of commissions to the customer. Under this regime, brokers sought to attract lucrative institutional business by offering various inducements to institutional customers. These included, particularly in the case of mutual funds, a willingness to give-up a portion of the commission to broker-dealers designated by the fund management, who were engaged in selling fund shares. Such give-ups represented additional compensation to these dealers for their selling activities. The exchanges chose not to regard this as a rebate. While this practice was questionable and was abolished by the exchanges in December 1968, it was permitted prior to that time as a means by which fund managers could obtain something of value for their excess commissions.

In the over-the-counter market, no fixed commission rate was imposed. The National Association of Securities Dealers, Inc., the self-regulatory body for the

over-the-counter market, was and is prohibited by law from maintaining fixed commission rates. The customer-directed give-up was not prevalent in that market and was, indeed, regarded as improper, if not illegal. As the Commission noted in December 1966: "A directed give-up of a portion of the commission charged for handling a transaction for a fund in the over-the-counter market would be a patent waste of investment company assets." [37]

Respondents point to the fact that it was the usual practice in agency transactions in the over-the-counter market to charge the New York Stock Exchange commission rates. This appears to be correct.[38] The conclusion which respondent derive from this, that price competition for execution services did not exist in the over-the-counter market any more than in the exchange market, does not follow. Nor does it further follow that because give-ups were accepted in exchange transactions, they were therefore also acceptable in over-the-counter transactions.

Although on small over-the-counter brokerage transactions the New York Stock Exchange commission was utilized as a familiar measure of a proper charge for the service, institutions were not required to, and usually did not, pay the high exchange commission on large over-the-counter transactions. They simply dealt directly over-the-counter market makers and were charged a mark-up substantially less than the applicable exchange commission.[39] Consequently, on insti-

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[37] Public Policy 178.

[38] *See Report of Special Study of Securities Markets of the SEC*, H.R. Doc. No. 95, pt. 2, 88th Cong., 1st Sess. 624 (1963) (hereinafter cited as Special Study).

[39] *Id.* at 627. But on the exchange, the transaction could not, of course, be executed for less than the minimum commission.

tutional transactions in the over-the-counter market there were no excess commissions to be disposed of by using customer-directed give-ups, and customer-directed give-ups were not utilized in that market.

Respondents argue that because the Commission's 1967 consent order precluded IOS from dealing directly with market makers, the IOS-managed funds had to pay excessive commissions and IOS had to divert the excess into its own pocket. The Commission, of course, did not intend such a result, and the order clearly does not provide for such. Nothing in the 1967 order required the funds to pay, or Lipper to charge, excessive commissions.[40] If for any reason an institution wished to execute an over-the-counter trade with a broker-dealer firm as agent rather than as principal, this could be done, and the commission could be negotiated, as IOS and Lipper might have done here.

Respondents claim to have relied on the advice of counsel, and they did have opinions of counsel which supported their course of conduct. Although neither ignorance of the law nor reliance upon counsel's opinions can make unlawful conduct legal, advice of coun-

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[40] Respondents appear to suggest that the practice of charging the stock exchange commission on over-the-counter transactions was not merely a practice, resorted to for convenience where appropriate, but rather reflected some type of agreement or conspiracy among broker-dealers to charge that rate under all circumstances. We can hardly assume the existence of such an agreement, particularly in view of the fact that, if practiced in the over-the-counter market where no statute affords the slightest justification for rate fixing, it would have been a flagrant violation of the antitrust laws.

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sel is often a weighty mitigating factor.[41] This is particularly true where the law is obscure or changing, or where the issues are technical and specialized, and a layman, therefore, requires the advice of counsel in order to chart a course.

But here the situation is different. The IOS respondents sought to divert the funds' money to themselves, and the Lipper respondents knowingly participated in this effort. In doing so, they relied upon counsel's conclusion that they had discovered a loophole in the law of fiduciary responsibility. Counsel, in turn, relied upon the fact that no contested decision or rule was precisely in point and specifically prohibited respondents' scheme. This type of reliance is misplaced, particularly in the area of fraud. Moreover, counsel actually knew (not merely should have known) that this agency considered give-ups by brokers in over-the-counter transactions to be "improper and illegal." [42] Counsel apparently disagreed

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[41] An act done in reliance on the advice of counsel may nevertheless be "willful" within the meaning of that term as used in Section 15(b) of the Exchange Act. This is so because for purposes of that section "a violation is 'willful' whenever the actor intends to do the act that constitutes the violation without regard to whether he specifically intends to violate the law." *Gerhart & Otis, Inc.*, 42 SEC 1, 28 (1964), *affirmed* 348 F. 2d 798 (C.A.D.C., 1965). *See also Tager* v. *SEC*, 344 F. 2d 5, 8 (C.A. 2, 1965).

[42] Public Policy 185. Respondents dismiss Public Policy as a mere essay that no one was obliged to heed. One part of that report dealt with the economics and the organizational patterns of the investment company business, as it was in 1966. Since those descriptions were based on exhaustive and protracted studies, we consider them authoritative. Another part of Public Policy—and the one pertinent here—contained a concise and carefully considered summary of this Commission's understanding of the then existing law, the law as it already was, with respect to investment companies.

with these views. That was their privilege. But both counsel and their clients were aware of the risk, and they can hardly claim that they could not reasonably foresee that the loophole which they perceived might prove to be illusory.

B. Jurisdictional Contentions

Respondents assert that their over-the-counter give-up arrangements are outside the Exchange Act's purview. They advance two reasons to support their contention. One is that the charges against them have no real connection with the purchase or sale of securities, but are matters involving internal corporate affairs. The other is that what is involved here is so foreign as to make the laws of the United States inapplicable.

It is true that nothing falls within the ambit of Section 10(b) of the Exchange Act or of Rule 10b-5 thereunder unless it be "in connection with the purchase or sale of any security." It necessarily follows that there is an area of internal corporate management untouched by the Exchange Act's antifraud provisions.

These generalities, however, have no bearing on the case before us. This case deals with nothing but securities transactions and the securities business.

A lawyer who told his clients that this was meaningless was counseling them to act at their peril. As the First Circuit said when it had to consider Public Policy's impact on *Moses v. Burgin*, 445 F.2d 369, 384 (C.A. 1, 1971), *cert. denied*, 404 U.S. 994 (1971): "Any contention that the Commission's views were off-hand or . . . inconsequential . . . is, to put it bluntly, little short of extraordinary. We may add that . . . willingness to disregard the Commission itself casts some doubt on the bona fides of a claim that the earlier expressed views of the staff were ignored because of its inferior position."

The foreign funds were investors and traders in securities. Indeed, that is all they ever did. The funds were constantly buying and selling huge blocks of securities. And they were continuously offering and selling their own shares to investors. Moreover, their shares were redeemable. Hence they were making continuing offers to repurchase their outstanding shares. In these circumstances we find it difficult to conceive of any significant aspect of their affairs that was not intimately connected with the purchase and sale of securities. We think it axiomatic that their expenditures for the brokerage services incident to such transactions were so connected.

Respondents support their contention that "foreign law rather than United States securities law is applicable" so that "the Commission is without jurisdiction or power over the allegations in this section of the order for proceedings" by pointing to Section 30(b) of the Exchange Act, which provides as follows:

"The provisions of this title or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this title."

We note at the outset that § 30(b) does not speak of a business in securities "without the United States," but rather "without the jurisdiction of the United States." The Lipper respondents and IPC were conducting a substantial securities business in the United States. Moreover, the transactions of con-

cern to us occurred in the United States. The Court of Appeals for the Second Circuit, in considering the reach of Rule 10b–5, has stated that "the nation where the conduct occurred has jurisdiction to displace foreign law and to . . . apply its own." [43]

Lipper Corp. and IPC chose to register with this Commission as brokers and dealers. When they did that, they voluntarily subjected themselves and their businesses to the jurisdiction of the United States.[44] In view of their controlling influence over Lipper Corp. and IPC, Lipper himself and OIS were also transacting a securities business within the jurisdiction of the United States. Accordingly, this Commission concludes that it has jurisdiction over the persons and the subject matter before it in this action.

[44] "Jurisdiction for purposes of Section 30(b) does not mean territorial limits." *SEC* v. *United Financial Group, Inc.*, 474 F.2d 354, 357–358 (C.A. 9, 1973).

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[43] *Leasco Data Processing Equip. Corp.* v. *Maxwell*, 468 F. 2d 1326, 1339 (C.A. 2, 1972) (Substantial conduct within the United States warrants application of Rule 10b–5 to transactions on the London Stock Exchange in securities not traded on the American markets.) In *IIT* v. *Vencap, Ltd.*, 519 F. 2d 1001, 1017 (C.A. 2, 1975) the Court of Appeals for the Second Circuit said: "We do not think Congress intended to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners. This country would surely look askance if one of our neighbors stood by silently and permitted misrepresented securities to be poured into the United States. By the same token it is hard to believe Congress meant to prohibit the SEC from policing similar activities within this country . . . ." And on that same day the court underscored this in the companion case of *Bersch* v. *Drexel Firestone, Inc.*, 519 F. 2d 974, 987 (C.A. 2, 1975), where it said: "We are . . . holding . . . that Congress did not mean the United States to be used as a base for fraudulent securities schemes even when the victims are foreigners, at least in the context of suits by the SEC or by named foreign plaintiffs."

C. Other Matters

The IOS respondents claim that the administrative law judge was disqualified because he reached certain conclusions and made certain findings in his initial decision dealing with the Lipper respondents before he issued his initial decision about the IOS phase of the case. He issued separate decisions to accommodate the exigencies of a situation engendered by IOS and IPC. On representations that settlement with IOS and IPC was imminent, the administrative law judge closed the record without prejudice to an application to reopen it if IOS and IPC did not settle as anticipated. When no such settlement was reached, he reopened the hearings on the issues relating to IOS and IPC. Meanwhile, he issued an initial decision dealing with the Lipper respondents. No showing of actual bias or prejudice stemming from an extrajudicial source that would warrant disqualification was made. The administrative law judge's findings against Lipper and Lipper Corp. were made in the course of his official duties. And his initial decision in the Lipper case expressly pointed out that its findings were not binding on IOS and IPC. Hence he was not disqualified from subsequently deciding common legal and factual issues against IOS and IPC.[45]

VI. REBATES OF BROKERAGE COMMISSIONS DERIVED FROM NEW YORK STOCK EXCHANGE TRANSACTIONS

As previously noted, commissions on New York Stock Exchange transactions were, during the rele-

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[45] *Transamerica Corporation*, 10 SEC 454, 473–474 (1941); *Kennedy, Cabot & Co., Inc.*, 44 SEC 216, 223 (1970). *Cf. Federal Trade Commission* v. *Cement Institute*, 333 U.S. 683, 702–703 (1948); *United States* v. *Grinnell Corp.*, 384 U.S. 563, 582–583 (1966); *Lyons* v. *United States*, 325 F.2d 370, 375–376 (C.A. 9, 1963).

vant period, divisible only among members of that exchange. Since neither IOS nor IPC was a New York Stock Exchange member, it would seem at first blush that there was no way in which they could derive direct pecuniary benefits from the New York Stock Exchange brokerage business placed by the IOS-managed funds. The IOS respondents, however, engaged in a scheme to obtain rebates of brokerage commissions paid on New York Stock Exchange transactions.[46]

The New York Stock Exchange commissions here under attack were paid by IPC's domestic fund, FOA, an investment company registered with us as such under the Investment Company Act.

The salient facts are these:

1. The IOS respondents gave some of FOA's New York Stock Exchange brokerage business to X Company, a New York Stock Exchange member firm. They did so because X Company had devised a technique for transmitting substantial chunks of excess institutional New York Stock Exchange brokerage back to the managers who placed orders with it.

2. X Company did not share the institutional New York Stock Exchange commission payments themselves with non-members. That would have been a blatant and an easily-detected violation of the New York Stock Exchange's anti-rebate rules. X Company's *modus operandi* involved the splitting of commissions generated by transactions in the over-the-counter

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[46] The Lipper respondents have no connection with this aspect of the proceedings.

market and on the Boston Stock Exchange.[47] The institutional manager with whom those commissions were divided had no connection with, and had never even heard of, the over-the-counter and Boston transactions in question. X Company's clients in these trades were generally not institutions. Yet X Company was ready, willing, and able to send a stream of money arising out of these transactions to any institutional manager who placed New York Stock Exchange business with it.

3. The amount of money that the institutional manager could expect to receive from X Company was directly related to the amount of New York Stock Exchange business he gave it. Thus, for example, an FOA New York Stock Exchange trade that produced a $5,000 commission for X Company would be followed by a $2,500 check from it to IPC.

4. X Company, however, was not a large firm. Neither its over-the-counter nor its Boston volume was large enough to create a give-up pool sufficient in size to satisfy the IOS respondents' desire for commission money.

5. At this point, Y Company, another brokerage house, became involved. Y Company was not a New York Stock Exchange member. But it had developed an ingenious "new technique" for arranging give-ups. The key to the new technique was Y Company's membership on the American Stock Exchange. Now

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[47] X Company was a member of both the Boston and the New York Stock Exchanges. Like most other regional exchanges, the Boston Stock Exchange permitted its members to divide commissions with other professionals in the securities business, whether or not they belonged to it or any other exchange. *See* Public Policy 171; *Moses v. Burgin*, 445 F.2d 369, 375–376 (C.A. 1, 1971) *cert. denied* 404 U.S. 994 (1971).

the simple two-sided arrangement of old was displaced by a triangular relationship among IPC, X, and Y, involving:

(a) The continued placement of FOA's New York Stock Exchange business with X Company—accompanied now, however, by the notation that the order had been placed with X Company, "courtesy of Y Company";

(b) X Company's placement with Y Company of enough American Stock Exchange business to produce net commissions for Y Company equal to the amount of the New York Stock Exchange commissions just paid by FOA to X Company;

(c) Y Company's subsequent disbursement of 52 percent of the commissions received from the American Stock Exchange business that X Company had forwarded to it to two of Y Company's registered representatives;

(d) The retention by those registered representatives of two percent of the aforementioned commissions to compensate them for their services as intermediaries; and

(e) The transmission of the 50 percent of these commissions to IPC so that the upshot of this series of maneuvers was the return to IPC of 50 percent of the commissions its *cestui que trust,* FOA, had paid X Company.

Since IOS and IPC were fiduciaries for the funds they controlled, neither of them was free to appropriate benefits derived from the execution of FOA's portfolio transactions for itself.[48] Of course, an investment company's manager may also be its broker.[49]

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[48] *See Provident Management Corp.*, 44 SEC 442 (1970); *Consumer-Investor Planning Corp.*, 43 SEC 1096 (1969).

[49] *See* Public Policy 71, 188–190.

When the manager acts as a broker, he is entitled to be paid for his work.[50] Here, however, neither IOS nor IPC ever supplied any brokerage services to FOA. Hence this is a twice-told tale. In the New York Stock Exchange context with FOA's commissions, just as in the over-the-counter context with the foreign funds' commissions, the IOS respondents used their strategic position in, and controlling influence over, the funds to collect brokerage income from them without supplying any brokerage services in return.

We find, as did the administrative law judge, that the IOS respondents' activities in connection with FOA's New York Stock Exchange transactions were in willful violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. We affirm and adopt as our own his holding that:

"No legal impediment precluded FOA instead of IPC from being the beneficiary of the arrangements . . . [T]he arrangements . . . constituted a fraud upon FOA and its shareholders for which IPC, and IOS as a participant in the scheme, must be held accountable. It is also manifest from the record that IOS and IPC withheld details regarding arrangements that had been made for the benefit of IPC from FOA and its shareholders. Full and complete disclosure of that information was required of IOS and IPC in order to meet the fiduciary responsibilities that they had assumed by their active intervention in the management of FOA. The failure of the respondents in this regard can only be viewed as

[50] Section 17(e)(2)(A) of the Investment Company Act permits persons affiliated with registered investment companies and persons affiliated with such persons to receive "the usual and customary broker's commission if the sale is effected on a securities exchange."

deliberate, and a deception that respondents felt necessary to the success of their scheme."

The IOS respondents argue that their conduct was justifiable under then existing industry practices and the New York Stock Exchange's rules. They claim that:

1. New York Stock Exchange anti-rebate rules made it impossible for FOA to benefit from the reciprocal payments.

2. Retail sellers of investment company shares commonly received reciprocal income from the funds' portfolio brokerage transactions.

3. The reciprocal income paid IPC, and through it to IOS, was simply additional compensation for IPC's services as the principal retail distributor of FOA's shares.

4. Both IPC and FOA would have been at a competitive disadvantage vis-a-vis other mutual funds and other mutual fund managers, had they been precluded from paying and receiving reciprocal income.

These contentions are without merit.

We begin by assuming *arguendo* that what respondents say about the impact of the New York Stock Exchange's anti-rebate rules is correct. On that assumption, no direct pecuniary benefits could have been passed back to FOA. Hence the IOS respondents had to choose between letting New York Stock Exchange members keep all of the commissions or devising some plan by which they, the respondents, could share in them.

Even if that had been the situation, respondents would not have been privileged to do as they did. True, direct price competition among exchange members was suppressed. But it does not follow that there was no competition at all among exchange members.

The sellers of New York Stock Exchange brokerage services were, in fact, in vigorous non-price competition with each other. In the institutional sphere, that non-price competition took several forms. One most significant form was a competition in supplying services to the institutions. Investment research was the principal form of such service.[51]

In the circumstances of this case, the IOS respondents were under a duty to deploy FOA's excess brokerage or "brokerage power" for the fund's benefit, not theirs. It follows that, if they had the capacity to cause any part of the commissions to leave the hands of the executing broker, they were bound to use that part to buy research and related services of value to FOA's shareholders. When respondents entered into their kickback arrangements with X and Y, they breached that duty. Those arrangements were of great benefit to respondents. But they did nothing at all for FOA. To the extent respondents chose to induce the executing broker to give up a portion of the commissions, they could not cause it to benefit themselves in preference to FOA.[52]

The rules of the New York Stock Exchange provide no more justification for the IOS respondents' re-

[51] *See* Public Policy 163–164.

[52] The peculiarities of the investment company context call for standards higher, not lower, than those that prevail elsewhere. *Cf. Brown* v. *Bullock*, 194 F. Supp. 207, 233 (S.D.N.Y., 1961), *affirmed* 294 F. 2d 415 (C.A. 2, 1961): "In light of the distinctive character of investment companies and their easy susceptibility to management abuses (e.g., looting of the companies by insiders using means both crude and subtle), one of the primary objectives of the 1940 Act was the protection of investment companies as well as investors against the derelictions of investment companies' directors, investment advisers, other fiduciaries, and principal underwriters."

tention of a portion of the commissions on the New York Stock Exchange transactions than they did on the over-the-counter transactions previously discussed. IOS and IPC were neither members of the New York Stock Exchange nor subject to its rules. And even if they had been, nothing in those rules would have compelled them to keep this give-up money for themselves. These are what we deem the controlling considerations:

1. Complex reciprocal and give-up arrangements, such as those that were entered into here, were designed for the very purpose of avoiding the New York Stock Exchange's anti-rebate rules. The over-the-counter markets and the regional exchanges were brought into the picture because the New York Exchange had no more than the most peripheral sort of control, if that, over the economic aspects of its members' activities on those markets.[53]

2. The New York Stock Exchange did not object to arrangements under which excess brokerage stemming from transactions on its floor was used to reduce an investment company's advisory fee. Hence it would have been quite easy to give FOA the benefit of these give-ups. But respondents had no desire to do that.

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[53] As the 1963 Special Study pointed out: "Return by an NYSE member of cash to his reciprocal correspondent for commission business would violate the anti-rebate rule . . ., but the return of a cash equivalent in the form of profitable security commission business which might have been transacted directly by the NYSE member is permissible . . . . The Exchange's published constitution and rules have never officially recognized a need to regulate reciprocal commission arrangements. Its rule 369 outlaws specific commission practices either outright or under specified conditions, but does not mention reciprocal arrangements with nonmember professionals." H.R. Doc. No. 95, pt. 2, 88th Cong., 1st Sess. 304.

3. Unlike the New York Stock Exchange, six of the seven regional exchanges permitted non-members who were professionals in the securities business to share in commissions arising out of transactions executed on them.[54]

Respondents' argument that the give-ups in question are analogous to those that were common in the investment company industry during the relevant period is misplaced. As the owner of FOA's investment adviser and manager and as the principal underwriter of FOA's shares, IPC's position was in no way comparable to that of a mere retail seller of fund shares to whom the adviser-underwriters of the various funds whose shares he sold directed reciprocal brokerage income by way of give-ups in order to provide an additional incentive to sell their shares. IPC was a fiduciary for FOA and its shareholders. The ordinary retail dealer is a merchant of mutual fund shares; no fiduciary relationship exists between him and his merchandise.

A mutual fund's adviser-underwriter needs no special incentive to promote the sale of shares in his own funds. His advisory fee supplies him with sufficient motive. And unlike the independent retail dealer, the adviser-underwriter has the entire sales charge at his disposal. Moreover, he has voluntarily bound himself by contract to exert his best efforts to promote the sale of the fund's shares.

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[54] Public Policy 171–173. "It would not be inconsistent with those rules for dealer-distributed funds to direct giveups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds." *Id.* at 173. *See also Moses* v. *Burgin*, 445 F. 2d 369, 375 (C.A. 1, 1971), *cert. denied* 404 U.S. 994 (1971).

To the independent retail dealer, on the other hand, the hundreds of mutual funds promoted and managed by the various competing adviser-underwriters present a wide choice. Within a broad area, he has no special reason to prefer to sell the shares of Fund Complex A rather than Fund Complex B. Hence the adviser-underwriters who sold through retail dealers were under strong competitive pressure to reward those dealers with give-up money.[55] The sale of FOA shares was already attractive to the IOS respondents. There was no need to make it even more attractive.[56] We think it clear that the give-ups in question were not engendered by competitive exigencies.[57]

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[55] Public Policy 170: "The customer-directed give-up has been used extensively by the funds. It permits them to entrust the execution of their portfolio transactions to a selected few brokers in whom they have special confidence and to reward with substantial cash payments the far larger group of brokers that distribute their shares."

[56] A high IOS official testified: "I very strongly urged [that] the firm 'profitability-wise' [would realize] much more residual benefits for the years to come through the building of a management fee than selling other people's funds even at maximum commission rates. I wasn't alone . . . . [E]verybody recognized that."

[57] Respondents' counsel treat the distinction between the adviser-underwriter who directed give-ups to unaffiliated retail dealers and their clients who directed give-ups to themselves as a distinction without a difference. We disagree. We see a very real difference between the two situations. It is true that the adviser-underwriters who scattered give-up largesse among hosts of retail dealers did so out of self-interest. By treating those dealers generously, the adviser-underwriter encouraged sales, thereby enhancing the size of the fund and his management fee. But IPC did not rely to any appreciable extent on independent dealers. It had its own sales force. And as a fiduciary, it could not retain any part of the give-ups.

The IOS respondents asserts that the FOA brokerage arrangements were adequately disclosed in its prospectuses. We see no substance to this disclosure claim.[58] We are in full accord with the administrative judge's holding that FOA's prospectuses were inadequate and misleading.

The prospectuses made various statements about brokerage and about the basis on which brokers were selected. Those statements were more or less standard in the mutual fund prospectuses of those days. Although they could have been sharpened to some extent, they did say that FOA might give its brokerage business to those who sold its shares. They also said that brokerage might be allocated "at the request of dealers including the Principal Distributor."

These "disclosures" certainly did not inform the ordinary investor that respondents were deriving direct cash benefits from FOA's brokerage without doing any work in exchange for those benefits. A prospectus must be clear and candid.[59] And FOA's prospectuses were at best murky and ambiguous. In their last brief to us, IOS respondents themselves concede that "in hindsight" the "disclosures may appear . . . overly cryptic."[60]

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[58] Respondents say that they were not responsible for FOA's prospectuses. In view of their control over every aspect of FOA's affairs and of the fact that the FOA prospectus was on at least one occasion amended to accommodate them, we must reject their claim.

[59] *See, e.g., Franchard Corp.*, 42 SEC 163, 184 (1964) and cases there cited. *See also The Wolf Corp.*, 42 SEC 1042, 1049 (1966): "The Act required a clear and uncomplicated statement in the prospectus of the basic facts."

[60] Respondents argue that the disclosures in the prospectuses must have been adequate because our staff "cleared" them. There

Respondents state that IPC collected $297,422 from X Company and Y Company as its share of FOA's New York Stock Exchange portfolio brokerage commissions. IPC ultimately returned this money to FOA. But it did not do so until after our staff had raised questions about the matter and had made it plain that it considered restitution the appropriate course. A refund made under such circumstances is no defense to the violations charged. And its mitigative weight is minimal.[61]

The above-described conduct with respect to FOA constituted a willful violation by IPC, willfully aided and abeted by IOS, of Section 17(e)(1) of the In-

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is no substance to that argument. To begin with, there is nothing in the record that even suggests that our staff knew that the prospectuses were supposed to disclose that the IOS respondents were taking FOA's excess brokerage. Secondly, "The burden of seeing to it that a registration statement filed with us neither includes any untrue statement of a material fact nor omits to state any material fact required to be stated therein or necessary to make the facts therein not misleading always rests on the registrant itself, and it never shifts to our staff." *Doman Helicopters, Inc.*, 41 SEC 431, 441 (1963). Thirdly, there can be no such thing as an estoppel against the Government in circumstances such as these. *Boruski* v. *SEC*, 289, F. 2d 738, 740 (C.A. 2, 1961); *SEC* v. *Culpepper*, 270 F. 2d 241, 248 (C.A. 2, 1959); *SEC* v. *Morgan, Lewis & Bockius*, 209 F. 2d 44, 49 (C.A. 3, 1953).

[61] As we said in *Richard K. Fudge*, 30 SEC 334, 339 (1949): "While restitution to defrauded persons is to be encouraged, we cannot, on that basis alone, permit violators to escape the consequences of their acts, particularly when restitution comes after discovery of their misdeeds." The significance of the refund to FOA is further diminished by the fact that no part of the far larger sums ($1,450,000 as against $297,422) derived from the foreign funds' over-the-counter brokerage commissions was ever returned to those entities.

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vestment Company Act.[62] As pertinent here, that section makes it unlawful for any affiliated person of a registered investment company, or any affiliated person of such person, "acting as agent, to accept from any source any compensation . . . for the purchase or sale of any property to or for such registered company . . . except in the course of such person's business as an underwriter or broker." IOS and IPC were affiliated persons of an affiliated person of FOA. And they also had the power to make FOA's investment decisions and to direct its portfolio transactions. Accordingly, they were "acting as agent" within the meaning of Section 17(e)(1).[63] Neither of them ever performed any brokerage or underwriting services in connection with the purchase and sale of FOA's portfolio securities. Those securities were FOA's "property" within the meaning of Section 17(e)(1).[64] Accordingly, the retention of the reciprocal benefits derived from FOA's portfolio transactions was an impermissible form of compensation proscribed by Section 17(e)(1). As affiliated persons who were not acting as brokers for FOA, IOS and IPC were subject to the prohibitions of Section 17(e)(1).[65]

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[62] As we have seen, unlike the foreign funds, FOA was a registered investment company.

[63] *Cf. United States* v. *Deutsch*, 451 F. 2d 98, 109–111 (C.A. 2, 1971) *cert. denied*, 404 U.S. 1019 (1972).

[64] *Id.* at 114. *See also Provident Management Corp.*, 44 SEC 442, 448 (1970); *Consumer-investor Planning Corp.*, 43 SEC 1096, 1101 (1969).

[65] As the Court of Appeals for the Second Circuit held in *United States* v. *Deutsch*: " '[A]cting as agent' is . . . a descriptive phrase distinguishing affiliated persons acting as brokers from those who are not acting as brokers in connection with a sale or purchase of securities for an investment company." 451 F. 2d at 111. As one commentator observes: "Section 17(e) is basically an antikickback provision. Its proscriptions apply when the af-

Violations of other sections of the Investment Company Act flow from the findings of violations of the antifraud provisions and the provisions of Section 17(e)(1). Thus, FOA's advisory contract failed to disclose, as required, that its manager's compensation would include payments to IPC attributable to the allocation of brokerage on FOA portfolio transactions. The proxy solicitation material used in connection with the March 1967 FOA stockholders' meeting and filed with us, and the April 1967 prospectus of FOA also filed with us, failed adequately to disclose that IPC would derive reciprocal income from the allocation of brokerage at its request and the inherent conflicts of interest detrimental to FOA. Under the circumstances, we conclude that IOS and IPC, which controlled FOA, willfully violated or willfully aided and abetted violations of Sections 15(a)(1), 20(a) and 34(b) of the Investment Company Act and Rule 20a-1 thereunder.[66] Those respondents also willfully aided and abetted violations of Section 31(a) of the Investment Company Act and Rule 31a-1(b)(9) thereunder, in that through the concealment of such infor-

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filiated person (or an affiliated person thereof) acts as an 'agent'; when the money received constitutes 'compensation'; and the activities giving rise to the compensation are not within 'the course' of the affiliated person's 'business as an underwriter or broker'." Butowsky, *Mutual Fund Brokerage*, 3 Rev. of Securities Regulation 915 (1970).

[66] Section 15(a)(1) prohibits a person from serving as an investment adviser of a registered investment company in the absence of a written contract precisely describing all compensation to be paid thereunder. Section 20(a) and Rule 20a-1 prohibits solicitations of proxies by means of a proxy statement containing any false or misleading statement of a material fact. Section 34(b) contains a similar prohibition with respect to documents filed or transmitted pursuant to provisions of the Investment Company Act.

mation, they caused FOA to maintain records which did not accurately reflect, as required, the basis for allocating its portfolio orders and the division of compensation on such orders.

VII. THE PUBLIC INTEREST

A. IOS

IOS is a shambles today. There is little reason to believe that it has any appreciable power to inflict further harm on investors. Nevertheless, we agree with the administrative judge that it is in the public interest to bar IOS from association with any broker or dealer.[67] That conclusion rests on two grounds.

The first relates to the gravity of IOS's willfull violations. When misconduct is as serious and as pervasive as that of IOS in this case, we think the burden is on the respondent to show us why something less than a total bar would be appropriate. No such showing having been made, anything short of a total bar would be inappropriate.[68]

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[67] *See Globe Aircraft Corp.*, 26 SEC 43 (1947) where we issued a stop-order suspending the effectiveness of a Securities Act registration statement even though the issuer had been adjudicated a bankrupt so that the possibility of future trading in the registered securities was extremely remote. We did so because we considered a "stop-order . . . a necessary corollary of our finding that the registration statement is false and misleading" and because we viewed such an order as the appropriate "means of formally terminating the effectiveness of the misleading document." 26 SEC at 55.

[68] Our 1967 order requiring IOS to conduct all its securities activities outside the United States does not warrant a different result. That order was in the nature of a resignation by IOS as a part of a settlement of charges based on entirely different facts. It can neither be equated with nor viewed as a substitute for a bar order predicated on findings of fact such as those made in this opinion.

Secondly, we must weigh the effect of our action or inaction on the welfare of investors as a class and on standards of conduct in the securities business generally. If these proceedings are to be truly remedial, they must have a deterrent effect on other investment company managers who may be tempted to enrich themselves at the expense of their beneficiaries.[69] We think that a total bar is necessary to provide the deterrent effect.

B. IPC

IPC's case differs materially from IOS's. IPC was a mere instrumentality. It was never an independent actor. Moreover, its present owners are wholly unaffiliated with IOS. It follows that a sanction against IPC could not possibly tend to achieve any remedial purpose. We therefore find it in the public interest to discontinue the proceedings, so far as they relate to IPC.

C. Lipper Respondents

In his initial decision the administrative law judge said that the Lipper respondents' violations "were serious and long continuing." He also found that:

"Lipper . . . did nothing to ameliorate [the] fraudulent practice until his own . . . financial success [was] assured. The picture that emerges from the record is of a man intent on personal gain and willing to take the risk that the scheme by which he could reach his goal would not be found illegal."

In spite of these considerations, the administrative law judge thought twelve-month suspensions appropriate. He saw no likelihood that the Lipper respond-

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[69] *Beck* v. *SEC*, 430 F. 2d 673 (C.A. 6, 1970) is inconsistent with these views. But we respectfully disagree with the holding of that case and decline to follow it.

ents' misconduct would be repeated. And he viewed the unfavorable publicity that they had already received because of the institution of these proceedings as being in itself a sanction of some severity.

The administrative judge is an adjudicator of long experience and great acumen. Hence we have considered his views with special care. We are, nevertheless, constrained to reject them. As we see it, the Lipper respondents were as culpable as IOS. In situations of this sort, the remitting broker and the receiving institutional manager are acting *in pari delicto*. Neither can accomplish his ends without the other. We cannot be as sanguine as the administrative law judge about future derelictions of this sort by the Lipper respondents. What we have before us is not some isolated indiscretion. Lipper Corp. owed its existence to IOS. And the Lipper—IOS relationship was rooted in the over-the-counter give-ups that flowed from Lipper to IPC.

Congress, in writing Section 15(b) of the Exchange Act, viewed past misconduct as the basis for an inference that the risk of probable future misconduct was sufficient to require exclusion from the securities business. Having been directed by the Act to draw that inference whenever our discretion leads us to consider it appropriate,[70] we must do so if the legislative aim is to be attained.[71] We think the likeli-

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[70] *See A. J. White & Co.*, Securities Exchange Act Release No. 10645, pp. 5–6 (February 15, 1974), 3 SEC Docket 550, 551–552; *Foelber-Patterson, Inc.*, 12 SEC 330, 336 (1942).

[71] In the securities business opportunities for dishonesty recor constantly. This necessitates specialized legal treatment. *See Archer* v. *SEC*, 133 F. 2d 795, 803 (C.A. 8, 1943), *cert. denied* 319 U.S. 767 (1943); *Hughes* v. *SEC*, 174 F.2d 969, 975 (C.A.D.C., 1949).

hood of future misconduct by the Lipper respondents sufficient to call for their exclusion from the securities business.[72] Moreover, as we have indicated in discussing IOS, that sanction will have a deterrent effect on other broker-dealers who may be inclined to participate in the fraudulent schemes concocted by investment company managers.

VIII. CONCLUSION

Our order will:

1. Bar IOS from association with any broker or dealer;

2. Discontinue the proceedings with respect to IPC;

3. Revoke Lipper Corp.'s broker-dealer registration;[73] and

4. Bar Arthur Lipper, III, from association with any broker or dealer.[74]

By the Commission (Chairman GARRETT, Commissioners LOOMIS, EVANS and SOMMER), Commissioner POLLACK not participating.

GEORGE A. FITZSIMMONS, *Secretary.*

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[72] This is so even though it appears that some years have now elapsed since they were last engaged in the securities business. That obviated any need for speedy action by us. However, the Lipper respondents are still legally free to engage in the securities business. Since we believe that this would be incompatible with the public interest, we are constrained to take appropriate preventive action.

[73] Lipper Corp. has applied for the withdrawal of that registration. Since we find revocation the appropriate course, we shall deny that request.

[74] The exceptions to the initial decision are overruled or sustained to the extent that they are inconsistent or in accord with the views expressed in this opinion.

SECURITIES EXCHANGE ACT OF 1934,
Release No. 11773/October 24, 1975

Admin. Proc. File Nos. 3–2156 and 3–2157

In the Matters of:

ARTHUR LIPPER CORPORATION, 140 Broadway,
New York, New York, (8–13182)

ARTHUR LIPPER, III

IOS, LTD. (S.A.), Geneva, Switzerland

INVESTORS PLANNING CORPORATION OF AMERICA
(now known as CIP, Inc.), New York, New York,
(8–12374)

ORDER IMPOSING REMEDIAL SANCTIONS AND DISCONTINUING PROCEEDINGS

On the basis of the Commission's opinion issued this day, it is

ORDERED that IOS, Ltd. (S.A.) be, and it hereby is, barred from association with any broker or dealer; and it is further

ORDERED that Arthur Lipper Corporation's request for the withdrawal of its registration as a broker and dealer be, and it hereby is, denied; and it is further

ORDERED that Arthur Lipper Corporation's aforementioned broker-dealer registration be, and it hereby is, revoked; and it is further

ORDERED that Arthur Lipper, III, be, and he hereby is, barred from association with any broker or dealer; and it is further

ORDERED that the proceedings with respect to investors Planning Corporation of America, now known as CIP, Inc., be, and they hereby are, discontinued.

By the Commission.

George A. Fitzsimmons, *Secretary*.

APPENDIX F

Statutory Appendix

SECURITIES EXCHANGE ACT OF 1934, 48 STAT. 881, AS AMENDED. REGISTRATION AND REGULATION OF BROKERS AND DEALERS.

Sec. 15(b)(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated—

*   *   *   *   *

(E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this chapter, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to

have failed reasonably to supervise any other person, if—

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

* * * * *

(6) The Commission, by order, shall censure or place limitations on the activities or functions of any person associated, or seeking to become associated, with a broker or dealer, or suspend for a period not exceeding twelve months or bar any such person from being associated with a broker or dealer, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed or omitted any act or omission enumerated in subparagraph (A), (D), or (E) of paragraph (4) of this subsection, has been convicted of any offense specified in subparagraph (B) of said paragraph (4) within ten years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of said paragraph (4). It shall be unlawful for any person as to whom such an order suspending or barring him from being associated with a broker or dealer is in effect willfully to become, or to be, associated with a broker

or dealer without the consent of the Commission, and it shall be unlawful for any broker or dealer to permit such a person to become, or remain, a person associated with him without the consent of the Commission, if such broker or dealer knew, or in the exercise of reasonable care should have known, of such order.

*   *   *   *   *

COURT REVIEW OF ORDERS AND RULES

SEC. 25. (a) (1) A person aggrieved by a final order of the Commission entered pursuant to this title may obtain review of the order in the United States Court of Appeals for the circuit in which he resides or has his principal place of business, or for the District of Columbia Circuit, by filing in such court, within sixty days after the entry of the order, a written petition requesting that the order be modified or set aside in whole or in part.

(2) A copy of the petition shall be transmitted forthwith by the clerk of the court to a member of the Commission or an officer designated by the Commission for that purpose. Thereupon the Commission shall file in the court the record on which the order complained of is entered, as provided in section 2112 of title 28, United States Code, and the Federal Rules of Appellate Procedure.

(3) On the filing of the petition, the court has jurisdiction, which becomes exclusive on the filing of the record, to affirm or modify and enforce or to set aside the order in whole or in part.

(4) The findings of the Commission as to the facts, if supported by substantial evidence, are conclusive.

(5) If either party applies to the court for leave to adduce additional evidence and shows to the sat-

isfaction of the court that the additional evidence is material and that there was reasonable ground for failure to adduce it before the Commission, the court may remand the case to the Commission for further proceedings, in whatever manner and on whatever conditions the court considers appropriate. If the case is remanded to the Commission, it shall file in the court a supplemental record containing any new evidence, any further or modified findings, and any new order.

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U.S. GOVERNMENT PRINTING OFFICE: 1977

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-291

SECURITIES AND EXCHANGE COMMISSION, *Petitioner*,

v.

ARTHUR LIPPER CORPORATION AND ARTHUR LIPPER III

RESPONSE TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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RESPONSE TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

INTRODUCTION

Arthur Lipper Corporation and Arthur Lipper III, respondents in an administrative proceeding conducted by the Securities and Exchange Commission ("SEC"), have petitioned this Court for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit to review that portion of the judgment of the Court of Appeals which affirmed the SEC's finding that Arthur Lipper Corporation and Arthur Lipper III (referred to herein as the "Lipper Respondents") had aided and abetted a violation of the SEC's Rule 10b-5. See Petition for Writ of Certiorari No. 77-275, filed in this Court on August 18, 1977.

The Petition of the Lipper Respondents raises significant issues regarding international jurisdiction, conflicts in governing law and administrative agency practices concerning an expansive interpretation of the SEC's Rule 10b-5; a rule which this Court recently considered. See *Santa Fe* v. *Green,* —— U.S. —— No. 75-1753, 97 S. Ct. 1293 (March 23, 1977); *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976); and *Sanders* v. *John Nuveen & Co.*, 425 U.S. 929 (1976), remanded 554 F2d 790 (CA 7, 1977). For the reasons more fully developed in their Petition, the Lipper Respondents urge this Court to grant certiorari on these issues. The decision of the Court of Appeals runs counter to this Court's interpretation of the SEC's Rule 10b-5. Moreover, the SEC has recently held that scienter, an element found necessary by this Court in the *Hochfelder* case to establishing a violation of Rule 10b-5 in a private litigation, is explicably not an essential ingredient when the SEC applies Rule 10b-5 in its own administrative proceeding. See *In re Steadman*, CCH Fed. Sec. L. Rep. Current Volume ¶ 81,243.

The SEC has recently been specifically instructed to consider the application of *Hochfelder* by the Court of Appeals for the District of Columbia in remanding to the SEC a broker-dealer, Rule 10b-5 appeal. *Collins* v. *Securities Corp.,* ——F2d —— (CADC No. 75-2200, August 12, 1977), CCH Fed. Sec. L. Rep. Current Volume ¶ 96,122.

In contrast to the primary issue raised in the Lipper Respondents' Petition—namely the obligations under Rule 10b-5 of members of the New York Stock Exchange ("NYSE") and the securities brokerage community in their relationships with institutional invest-

ors—the instant Petition of the Solicitor General filed on behalf of the SEC simply reflects the SEC's anger with the Court of Appeal's "audacity" to disagree with the vengeful and most severe penalty the SEC imposed upon the Lipper Respondents. Although the Solicitor General stresses the importance of administrative discretion in the selection of remedy, the real issue is the extent reviewing courts will tolerate agency abuses where the agency combines the roles of arresting officer, prosecuting attorney, judge, jury, as well as appellate tribunal.[1]

The Lipper Respondents urge that whether they are barred permanently from participation in the securities business, the punishment inflicted by the SEC, or whether they are only subjected to the retroactive 12-month suspension imposed by the Court of Appeals, is not an issue warranting this Court's review.

Since 1969 when the Lipper Respondents had their first opportunity to settle this matter with the SEC through the common, SEC staff-desired procedure of "consenting" to a finding of wrongdoing (without admitting the allegations) and accepting a mild sanction of little economic significance, the Lipper Respondents' overriding concern has been one of reputation, and their regard for applicable law. Thus, the Lipper Respondents continue to assert their right to defend

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[1] Indeed, the Court of Appeals for the District of Columbia has recently held that the standard of proof in an SEC broker-dealer, Rule 10b-5 proceeding, such as the one in issue here, is "clear and convincing evidence" not "preponderance of the evidence" because the severity of the sanction "renders the proceeding quasi-criminal in nature". *Collins v. Securities Corp.*, —— F2d —— (CADC No. 75-2200, August 12, 1977), CCH Fed. Sec. L. Rep. Current Volume ¶ 96,122 at 92,045.

against the SEC's total disregard of the fact that the Lipper Respondents were acting in an independent professional capacity vis-a-vis IOS, the SEC's major target. The Lipper Respondents never doubted the SEC staff's ability to guide whoever was then sitting as SEC commissioners to the ultimate objective sought by the staff, *i.e.*, damaging IOS in all respects, even to the extent of attempting to ruin an independent organization, which was providing non-U.S., bonafide financial institutions with securities brokerage services. In obviating any economic consequence of the sanction, the Court of Appeals selected the easy way out and avoided full consideration of the basic issues raised by the Lipper Respondents. The Court of Appeals effectively relieved the SEC from shouldering its burden of proof and at the same time avoided entering the murky waters of securities industry practice and SEC policies of eight years previous. Although relieving the Lipper Respondents of the effects of the SEC sanction, the Court of Appeals was unsuccessful in righting a wrong because the Lipper Respondents still suffer the stigma of a finding that they perpetrated an illegal act.[2]

REASONS FOR DENYING THE SOLICITOR GENERAL'S PETITION

Based upon his finding that the Lipper Respondents had aided and abetted in a violation of Rule 10b-5, the SEC's Administrative Law Judge (*i.e.*, the trial hearing examiner) proposed a 12-month suspension of the Lipper Respondents from the securities business. (39A)[3] The SEC chose to accept staff recommended

[2] A direct consequence of the stigma is the assertion by the Internal Revenue Service that the shared commissions were illegal rebates resulting in a $761,195 tax claim.

[3] "A" refers to pages in the Appendix to the Petition of the

sanctions, to overturn its administrative judge, "an adjudicator of long experience and great acumen" (76A), and instead imposed the harshest possible penalty of a complete and permanent bar from the securities business. The SEC's action was based on the following conclusions:

1. "We think the likelihood of future misconduct by the Lipper Respondents sufficient to call for their exclusion from the securities business." (76A-77A)

2. The ". . . sanction will have a deterrent effect on other broker-dealers who may be inclined to participate in the fraudulent schemes concocted by investment company managers." (77A) [4]

The Court of Appeals specifically took cognizance of the prevailing precedents which have delineated the appropriate role a Court of Appeals plays in reviewing SEC penalty determinations. See page 25A. In so doing, the Court of Appeals correctly considered (25A, footnote 10) that an administrative agency's penalty should not be altered unless the penalty is "unwarranted in law or is without justification in fact", citing *American Power Co.* v. *SEC,* 329 U.S. 90, 112-13

Solicitor General. In actual fact, the Administrative Law Judge recommended that Arthur Lipper Corporation be suspended for 12 months from executing transactions in the over-the-counter market only, thereby permitting Arthur Lipper Corporation to continue executing transactions on all national securities exchanges. Mr. Lipper would have been barred from association with the firm for the 12-month period.

[4] In this latter respect, the SEC noted (75A, fn. 69) that it declined to follow the Sixth Circuit's decision in *Beck* v. *SEC,* 430 F2d 673 (CA 6, 1970).

(1946) and *Butz* v. *Glover Livestock Commission Co. Inc.,* 411 U.S. 182 (1973). In other words, the Court of Appeals was fully aware of this Court's rule that an administrative agency's choice of sanction may be altered only when the reviewing court is satisfied that the administrative agency has abused its discretion. The court applied that rule to the facts of this case.

The Court of Appeals found the SEC's penalty "was too severe" (26A) and *"under the circumstances of this case . . . an abuse of discretion."* (28A) (emphasis added). As noted by the Court of Appeals, the SEC's penalty was not necessary to prevent the Lipper Respondents from participating in give-up arrangements because customer directed give-ups, the practice herein involved, had been abolished in December 1968. In addition, the Court of Appeals was aware of the SEC's recent concession (in an *amicus* brief filed in another case pending in that court) that the period in question (namely 1967 and 1968) "were years of considerable uncertainty as to the regulatory climate concerning give-ups" (27A); indeed, as the record of this case makes clear, give-up arrangements of all kinds pervaded the securities industry and were almost universal in the case of investment companies.

In fact, the SEC was a leading contributor to this uncertainty. During this period of time the SEC was in the forefront of the battle to require the national securities exchanges to ban give-up arrangements as inconsistent with the exchanges' fixed, minimum commission rate structure—the SEC's ultimate objective. It is not surprising that the SEC, as first an advocate and then a judge, would not consider this set of facts to be mitigating circumstances. It is for this very rea-

son that the fair and orderly administration of justice requires that a Court of Appeals be equipped to temper the enthusiasm of the overzealous administrative agency and bring to bear a more dispassionate overview to the proceedings. The SEC's capability of ruining reputations, businesses, and individuals must be controlled by a system requiring the dispassionate adherence to the laws protecting an accused. Neither legal nor moral right is always on the side of the regulator.

In measuring the penalty to be imposed upon the Lipper Respondents, the Court of Appeals pointed to many factors:

1. the Lipper Respondents "were living in a world of customer-directed give-ups". (27A)
2. ". . . many other competing brokers were directing" give-up payments to the same broker as the Lipper Respondents. (27A)
3. the Lipper Respondents "did act under the supervision of experienced although in our view not disinterested counsel". (27A) [5]
4. ". . . there is no evidence that they [the Lipper Respondents] had any thought they were violat-

[5] Both the Court of Appeals and the SEC made much of the fact that the counsel selected by Mr. Lipper was not disinterested since the same counsel had been retained by IOS, the adviser to the institutional customers of Arthur Lipper Corporation. However, it sometimes is forgotten that a businessman in good faith quite naturally seeks out the most knowledgeable and competent counsel who is familiar with the complicated legal ramifications of the securities business. Neither the SEC nor the Court of Appeals explained why the alleged "sins" of the counsel should be visited upon Mr. Lipper. The relationships were fully disclosed. The fact remains that Mr. Lipper, in good faith, relied upon the advice of knowledgeable and competent legal counsel.

ing the law—unless, of course, it were the law that any give-up on OTC [over-the-counter] business was fraudulent, which they had been advised, perhaps correctly, was not true." (27A)

5. "We are moved also by the inordinately long time in which this proceeding has been pending, particularly the unexplained lapse of over three years from the argument to the decision of the Commission [and] the cloud that has hung over petitioners' heads during this period." (27A)

6. Another consideration was "the tremendous disparity between the sanctions invoked against petitioners and that imposed on two other brokers whose violations were perhaps more clear". (27A)

7. The Court of Appeals believed that "some weight may properly be given to his [the Administrative Law Judge's] opportunity to observe Lipper and others who played a part in the acts here in question and in fashioning a remedy in light of that observation". (27A-28A)

Based upon the foregoing detailed listing of the circumstances of this particular case, the Court of Appeals quite appropriately concluded that the severe sanction selected by the SEC was an abuse of discretion. Hence, in reviewing the remedy selected by the SEC, the Court of Appeals meticulously followed the controlling precedents of this Court.

The SEC apparently does not contend openly that its selection of a remedy may never be overturned by

a reviewing Court of Appeals. However, it is hard to imagine the circumstances in which the SEC would agree that a Court of Appeals acted properly in overturning an SEC penalty. See *Beck* v. *SEC*, 430 F2d 673 (CA 6, 1970), which the SEC declines to follow. However, the Solicitor General argues (Petition p. 9) that the Court of Appeals failed to follow this Court's decision in *Glover Livestock*, *supra*, because the Securities Exchange Act of 1934 "reflects a congressional recognition that expulsion is generally the appropriate sanction for a serious violation . . ." and the "court of appeals did not question the seriousness of the respondents' violations".

The Solicitor General is wrong on both counts. First, the range of sanctions in the statute[6] merely means that Congress gave the SEC a wide choice of remedies —it would only suggest to the most prejudiced mind that by providing for a wide selection, the Congress intended that the SEC always impose the most harsh sanction. Secondly, a cursory glance at the factors we have listed above which the Court of Appeals found were the circumstances which led the court to reduce the permanent expulsion, demonstrates that the Court of Appeals did not share the SEC's view of the seriousness of the conduct of the Lipper Respondents. Inescapably involved in this case is the fact that the SEC had criticized the self-regulatory bodies governing the securities industry (*i.e.*, the New York Stock Exchange, other national stock exchanges and the National Association of Securities Dealers) for authorizing and promoting give-up practices among members

[6] **Section 15(b)(4)(E) of the Securities Exchange Act of 1934, 15 U.S.C. (Supp. V) 78o(b)(4)(E).**

of the brokerage community. Also, it is unquestioned that the SEC at all times had the authority to adopt a rule banning give-ups, an alternative it failed to select. This state of the law in 1967-1968 was a significant factor in the advice given to the Lipper Respondents by their counsel.

Because of the SEC's failure to adopt a rule banning give-ups, the SEC staff attempted to "prove" violations of the SEC's Rule 10b-5 on "evidence" that the SEC had declared over-the-counter give-up arrangements unlawful in statements in various SEC studies and in a letter written by an SEC staff official. See the Court of Appeal's discussion of this SEC tactic at pages 8A-11A. The Court of Appeals quite properly overruled the SEC's findings that such statements constitute evidence of fraud *per se*. But it is understandable that the SEC was incensed that a member of the regulated brokerage community accepted the opinion of its independent counsel, himself a former high official of the SEC, that statements in SEC studies are views and do not have the force of law. In the absence of a rule banning give-ups, which the SEC had at all times full authority to adopt, counsel's client could accept the opinion that they were acting in conformity with the law.

It was not until the Lipper Respondents introduced into the record of this administrative proceeding evidence that members of the NYSE uniformly charged all clients the same NYSE minimum commission rate on all over-the-counter agency transactions that the SEC was reluctantly forced to acknowledge this fact. By recognizing the universal application by NYSE members of charging the NYSE minimum commission

rates on over-the-counter agency transactions, the Court of Appeals rejected the SEC's contention that the Lipper Respondents had the legal obligation to negotiate reduced brokerage commissions. It is clear that had the Lipper Respondents retained the full commissions charged, the effect on the shareholders would have been identical to that which actually occurred. Were there not to have been a sharing of commissions as permitted and encouraged by the self-regulatory bodies, the SEC would have had no cause for complaint. In addition, the Court of Appeals would not have had an opportunity to advance its unique interpretation of law imposing new responsibilties on independent brokers to police the fiduciary responsibilities of the investment adviser (IOS) to the broker's clients; even clients domiciled outside the United States.

Finally, it is noteworthy that the prior SEC statements were those of a regulator advocating a change in accepted industry practices; the statements were not issued in the SEC's judicial capacity. And when the SEC brought this case against the Lipper Respondents, it selected its own forum, electing not to bring an injunctive action before a disinterested district court judge—an avenue clearly available to the SEC.

It is this very kind of situation which requires a reviewing Court of Appeals to temper the zeal of the administrative agency which is out to justify its prior pronouncements as a regulator, when such pronouncements are called into question and come before the agency in its judicial capacity. However necessary it may be to the administration of justice to permit the regulator to be both prosecutor and judge, a reviewing court must be alert to the abuses which frequently can follow from this inherent weakness in the administra-

tive process. Moreover, this is not a situation involving a complex financial restructuring of an industry where the expertise of the SEC need prevail.

The contention that the Lipper Respondents had to be permanently barred from the securities industry because of the likelihood of their future misconduct was patently unacceptable to the Court of Appeals. The Court of Appeals pointed out that give-up practices were banned by the self-regulatory bodies in December 1968 and not through SEC rule-making; and, therefore, public investors had nothing to fear in this regard. Moreover, the Solicitor General has not explained why the SEC was willing to accept settlements imposing suspensions of 15 calendar days and 21 business days on other broker-dealers who participated in conduct which was more clearly a violation than the conduct of the Lipper Respondents. If the SEC is really concerned about the deterrent value of the penalties it imposes, it would seem that the other broker-dealers should have also been permanently barred. And it is in this context that the Court of Appeals undoubtedly noted the disparity of sanctions imposed; for the disparity completely destroys the SEC's "deterrent theory".

The real fact is that the SEC's entire enforcement program depends upon "consent cases". A businessman who finds himself engaged in an SEC litigation makes a practical judgment that if he is to continue in business he must "play ball with the SEC" and consent. The businessman, of course, avoids the enormous costs connected with protracted litigation with the SEC and the attending adverse publicity. Moreover, he is allowed to consent without admitting the SEC's

allegations. From the SEC's standpoint, a consent order is a complete "victory", particularly where the consent includes an agreement that the SEC may write an opinion. New precedent can be established without benefit of the traditional adversary system and the scrutiny of judicial review by a truly disinterested body. But, where as here, a respondent sincerely believes it is his unfettered legal right to seek vindication by refusing to consent and demands that the SEC *prove* its case, the agency must teach others of like persuasion that exercise of one's rights in the administrative forum can be a dangerous and costly proposition. Others are taught a clear lesson—anyone, including attorneys, who fail to knuckle under to the will of the prosecuting staff members can expect continued harrassment, antagonistic treatment and when possible in the staff's power the harshest of sanctions. "Consenting" has become the expedient for the businessman unwilling to accept the cost and attendant publicity of challenging the SEC.

CONCLUSION

For the foregoing reasons the Lipper Respondents urge this Court to deny the Petition of the Solicitor General. The Lipper Respondents believe that the issues raised in their Petition No. 77-275 warrants review by this Court. In any event, it would be a gross miscarriage of justice to grant the Petition of the Solicitor General and at the same time deny the Petition of the Lipper Respondents.

Respectfully submitted

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No. 77-291

In the Supreme Court of the United States

OCTOBER TERM, 1977

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

ARTHUR LIPPER CORPORATION AND ARTHUR LIPPER, III

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION

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Respondents rely heavily on the court of appeals' observation (Pet. App. 27A) that they had been "living in a world of customer-directed give-ups." They argue (Response to Petition 9) that the New York Stock Exchange and other national stock exchanges authorized and promoted give-ups among their members, and suggest that their conduct was indistinguishable from that of their fellow members on the New York Stock Exchange during the period in question. Their contention apparently is that for these reasons their violations of the anti-fraud provisions of the federal securities laws were neither particularly serious nor indicative of unsuitability for the securities business, and that the court of appeals therefore was justified in changing the sanction the Commission had imposed.

The "give-up" scheme in which respondents played a central role, however, was a far cry from the give-ups common during the period in question. At that time, the constitution and rules of the New York Stock Exchange required that its members charge certain fixed commission rates on transactions executed on that Exchange, and forbade rebates (Pet. App. 4A). Despite this across-the-board rule, large institutional customers, such as mutual funds, that had tremendous bargaining power became aware of the economies of scale inherent in the execution of their securities transactions, and insisted that brokers devise a method by which they could, in effect, reduce their commission charges accordingly.

In response, the practice of "give-ups" evolved, whereby an institutional customer required a member broker to transfer a portion of the commission payments it received for Exchange transactions to another member broker who had been uninvolved in the particular transaction in which this commission had been earned, but who had performed some other service for that institutional customer.[1] See Securities and Exchange Commission Report to Congress on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 162-163, 169-172 (1966). The Exchange's fixed commission schedule was technically preserved by the give-up device, since the fixed rate was charged and never returned to the customer. But the institutional customer was able to take economic advantage of its bargaining power by transferring a portion of its commission payments to third persons in return for services they had performed for the institutional investor that were unrelated to the transaction on which the commission arose.

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[1]Typically, the member broker which received the give-up was engaged in the distribution of the institutional customer's shares to the public.

The transactions in this case, however, took place in the over-the-counter market,[2] where there was no fixed commission schedule[3] that might arguably have provided either an economic—or legal—justification for give-ups.

Even more importantly, the give-up scheme in which respondents played such a critical role was not a device designed to confer an indirect benefit on the mutual funds by permitting them to direct that part of the commission fees they paid be transferred in turn to third persons to whom the funds owed some unrelated financial obligation. Instead, the give-ups here were used to defraud the funds by enabling IOS, the manager of an investment funds, "simply to pocket give-ups which [it] ha[d] diverted to [it]self" (Pet. App. 12A). Respondent Lipper Corp. knowingly assisted this scheme by charging its customers, the IOS-affiliated mutual funds, a commission which apparently far exceeded respondent's cost of executing the funds' transactions at a reasonable profit, and then diverting 50 percent of those commissions to IOS itself.

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[2]Transactions in securities not taking place on an exchange are referred to as over-the-counter transactions. The over-the-counter markets, unlike the exchanges, have no centralized place for trading. * * * [A]ll registered broker-dealers are entitled to participate. The broker-dealers vary in size, experience and function; the securities differ in price, quality and activity.

Securities and Exchange Commission, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 2, 541 (1963).

[3]When Congress amended the Securities Exchange Act in 1938, it expressly prohibited national securities associations, such as the National Association of Securities Dealers (the self-regulatory entity performing the same initial oversight function for the over-the-counter market that the exchanges perform for the exchange markets) from fixing commission rates in any way. See Section 15A(b)(6) of the Securities Exchange Act, as added, 52 Stat. 1070, and amended, 15 U.S.C. 78*o*-3(b)(6).

Respondents' entire effort to analogize these payments to exchange give-ups is an attempt to cloak with an air of legitimacy a scheme to kick-back to a fiduciary monies diverted from those to whom the fiduciary owed a special obligation of trust and confidence. As the court of appeals expressly noted, "there was nothing in all this that should have induced a belief that give-ups could be utilized for the benefit of the adviser rather than of the fund" (Pet. App. 27A).

Although respondents assert that the court "recogniz[ed] the universal application by NYSE members of charging the NYSE minimum commission rates on over-the-counter agency transactions" (Response to Petition 10-11), the court of appeals concluded that respondents' "prevailing practice argument [was] considerably overstated" (Pet. App. 22A), and emphasized the crucial distinction between respondents' conduct and other instances where there had been give-ups on over-the-counter transactions. While other brokerage firms had provided give-ups—at IOS's direction—to its subsidiary Investors Planning Corporation (IPC), the court found that nothing in the record indicated that those firms were aware that IOS owned 80 percent of IPC, or that IPC had performed no services in return for the monies channeled to it (*ibid.*). Thus no other firms were shown to have knowingly and systematically assisted IOS's use of give-ups not to confer any benefit—direct or indirect—on the mutual funds, but instead to line the pockets of the funds' investment adviser, IOS, at the funds' expense. Indeed, Lipper Corp. was formed for the very purpose of serving as IOS's link to the American securities market and carrying out this scheme (Pet. App. 4A).

The court of appeals affirmed the Commission's conclusion that respondents' payments to IOS constituted serious violations of the federal securities laws. The only question presented in this petition is whether the court of appeals could nevertheless substitute its judgment regarding the sanction that the public interest requires for that of the Commission. For the reasons stated in the petition, the court exceeded the proper scope of judicial review in doing so.

Respectfully submitted.

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